Rent Control and Options for Decontrol in Ontario

Policy Study Series

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Richard Arnott
with the assistance of
Nigel Johnston

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Policy Study Series — Ontario Economic Council

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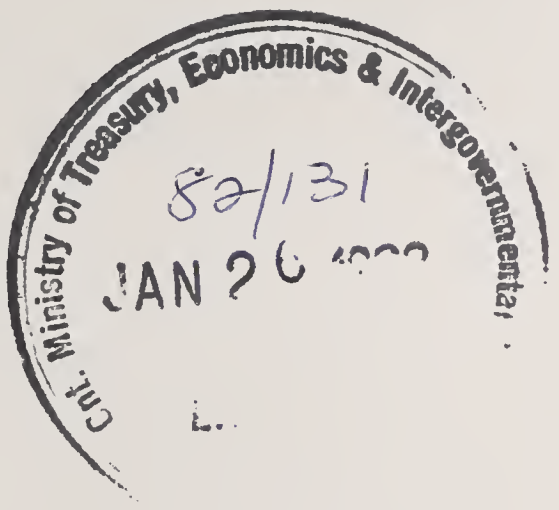

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Contents

Figures v

Tables vi

Acknowledgments vii

1
Introduction 1

2
The current rent control program in Ontario 4

3
The effects of rent control: the existing literature 18

4
The effects of rent control: a new model of the housing market 38

5
Decontrol 72

6
Policy recommendations 103

Appendix A
The structure of rent control in Ontario 122

Appendix B
The decontrol experiences of other jurisdictions 139

Appendix C
The rent control and decontrol experience in New York City 150

Appendix D
Vacancy rates and rent increases in Canada 169

Bibliography 180

Figures

1 Supply-demand analysis of the housing market 34
2 Supply-demand analysis of rent control 35
3 The housing stock over time 39
4 The rent and value gradients 41
5 Equilibrium rent gradients and the allocation of housing 43
6 Quality and maintenance expenditures as functions of age 47
7 Pure guideline increase controls 51
8 Pure cost pass-through controls 61
9 Mixed guideline increase/cost pass-through (GI/CPT) controls (Ω flatter than $r - m = k$) 64
10 Mixed guideline increase/cost pass-through (GI/CPT) controls (Ω steeper than $r - m = k$) 66
11 Decontrol: effects on maintenance expenditures 80
12 Decontrol: effects on rents 82
13 Volume of new housing construction: two cases 86

Tables

1 Computation of unit basic rent increases in Ontario 9

2 Vacancy rates for ten Ontario cities 106

A.1 Computation of unit basic rent increases in Ontario 132

B.1 Increases in rents free to rise after termination of federal rent control in cities: all rent ranges 145

B.2 Percentage increases in rent indexes after decontrol for ten U.S. cities 146

C.1 A chronology of rent regulation in New York City 151

C.2 Control status of renter-occupied units, New York City 152

C.3 Standard guideline allowances, 1968-79 155

C.4 Gross rents, by control status, for matched renter-occupied housing units, New York City, 1975-8 167

D.1 Vacancy rates: twelve Canadian cities 174

D.2 Rent indexes: twelve Canadian cities 175

D.3 Econometric results for twelve cities of 177

$$\ln n_j^t = k_j + \alpha_1 \ln v_j^{t-1} + \beta_1 \ln i^{t-1}$$

D.4 Econometric results for twelve cities of 178

$$n_j^t = c_j + \hat{k}(v^{t-1})^{\alpha_1} + \beta_1 i^{t-1}$$

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1
Introduction

Ontario has had rent control[1] since December 1975. This is long enough to justify both a review of the effects of controls on the housing market and an assessment of ways in which rent control legislation might be modified in the future.

The provincial government has three choices. First, it can retain the existing rent control scheme, in which case it may decide that some legislative and administrative changes are needed to improve the program's operation. Second, it can replace the existing program with an entirely new scheme, in which case the issue is which alternative form of controls is 'best'. Finally, the government can decide to end controls entirely; the question in this case is how to decontrol in an efficient and equitable manner.

The analysis of these choices - that is, of the ways in which the government might improve, replace, or abolish the current rent control program - constitutes the substance of this study. Although we offer specific policy recommendations, our primary purpose is to provide a useful basis for discussion rather than definitive answers. Indeed, given the extreme scantiness of hard data respecting housing markets and rent control programs, both inside and outside Ontario, we could not provide such answers in any case. Thus the modesty of our purposes complements the modesty of our present resources.

Much of the study is devoted to positive analysis - that is, to explaining the existing rent control program and the economic effects of

1 Here and throughout the study, we use the term 'rent control' loosely. By it, we mean that rent increases are subject to review or regulation, not that they are directly controlled or fixed by the government. Note that we employ the terms 'rent control', 'rent review', and 'rent determination' virtually interchangeably.

various rent control and decontrol policies. Chapter 2 describes current rent control legislation and administration in Ontario and suggests some modifications to both. Chapter 3 provides a brief survey of existing popular and technical literature on rent control. Chapter 4 develops a new model of the housing market, one suited to the investigation of rent control, then uses this model to explore the qualitative effects of three illustrative rent control programs. Chapter 5 introduces various decontrol options and discusses some of the effects and the pros and cons of each. A theme that pervades the economic analysis in Chapters 3, 4, and 5 is that the effects of a particular rent control or decontrol program are both complex and sensitive to the details of the program. It is hoped that the reader will come away from the positive anaysis with a better understanding of the economic effects of rent control and also with an awareness that the policy issues are subtle and complex, rather than simply a matter of control versus decontrol.

Chapter 6 draws on the positive analysis to develop an argument concerning what the government should do vis-à-vis rent control and decontrol; it ends with a set of policy recommendations. In keeping with the modest scope of the study, we consider only a limited range of options. In particular, we take as given all other government policies that directly or indirectly influence the housing market. Thus we do not consider in any detail the desirability of policies such as replacing rent control with a system of progressive rent subsidies, of supplementing it with maintenance subsidies, or of introducing accelerated depreciation. Furthermore, in the absence of adequate quantitative data, our policy discussion is based perforce largely on a priori arguments, supplemented by some casual evidence. Such a discussion is certainly useful, but it cannot be as persuasive as a careful, thorough, and sophisticated quantitative study, which would make it possible to obtain precise predictions about the effects of various policy options. Finally, the appendices provide a fuller treatment of some points that were, for the sake of balance, summarized in the text.

The hurried (harried) reader who wants only the gist of the policy argument is referred to the concluding section of Chapter 6. Reading only this section, however, will not be very informative, since its argument draws heavily on the analysis in the preceding chapters. The non-economist may find the more technical portions of Chapters 4 and 5 hard

going. He may skip these sections on a first reading, as the results of the economic analysis in Chapter 4 are summarized at the end of the chapter, while the earlier part of Chapter 5 provides a less-technical discussion of the material in the subsequent section. Yet we advise the reader to persevere and return to the economic analysis: a good understanding of the economic effect of rent control is necessary if it is to be discussed usefully.

2
The current rent control program in Ontario

The first two sections of this chapter describe the essential features of the Residential Tenancies Act and its administration. The third suggests some modifications of the existing program.

THE EXISTING LEGISLATION

Ontario's system of rent control came into existence in December 1975, when the Residential Premises Rent Review Act (hereafter called the Rent Review Act) received royal assent. This act was repealed in November 1979 by the proclamation of the Residential Tenancies Act. This section will discuss only the latter and only its highlights. Appendix A provides a more detailed and precise discussion of the Residential Tenancies Act, as well as a comparison of it with its predecessor.

The broad features of the Residential Tenancies Act are clear. With a few minor exceptions, it applies controls to all rented residential premises built before the original implementation of controls in 1975. Landlords are allowed an automatic rent increase of up to 6 per cent per year. If a landlord wants to increase his rents by more than 6 per cent, he must apply to the Residential Tenancies Commission for rent review. The review process considers three factors: the landlord's increase in costs, his rate of return (defined later in this chapter), and any changes in the standard of maintenance and repair.[1] The commission may, at its discretion, grant a landlord an increase in rents sufficient to bring his rate of return up to 2 per cent; if his rate of return is already 2 per cent

1 The commission's position regarding consideration of the standard of maintenance and repair in rent determination is unclear, as the relevant portion of the act, section 28, has yet to be proclaimed.

or more, then the increase he is allowed may be no greater than his increase in costs.

Although the Residential Tenancies Commission can limit rent increases at its discretion, it may be said that, in general, the system allows the landlord a rent increase equal to the maximum of the guideline increase of 6 per cent, or his increase in costs, or the amount required to bring his rate of return up to 2 per cent. Thus the landlord can, in effect, choose the method of control most agreeable to his interests - that is, the one that gives him the largest profit.

A feature of a rent control program that allows a landlord to increase his rents by a certain percentage amount is generally called a guideline increase provision. A provision that allows him to increase his rents by an amount equal to his increase in costs is termed a cost pass-through provision. A guarantee to the landlord of a certain rate of return is called a hardship, loss, or rate-of-return provision. Thus Ontario's rent control system is of the guideline increase type with cost pass-through and rate-of-return provisions. Since the rate-of-return provision is relatively unimportant, little is lost by treating the Ontario program as though it were of the guideline increase type with cost pass-through alone (GI/CPT). This is, in fact, how it is treated in Chapter 4, which analyses the economic effects of various types of rent control, and in Chapter 5, which investigates decontrol options.

Several other features of the Residential Tenancies Act are worth noting from the outset. First, it channels appeals to a panel in a procedure that is easy and informal compared to that of the court system. (This system was established in the earlier Rent Review Act. In drawing up the new act, the government sought to extend this relatively simple appeal procedure to the resolution of landlord and tenant disputes; more specifically, the Residential Tenancies Act was to replace both the Rent Review Act and the Landlord and Tenant Act. At the time of writing, however, those provisions of the Residential Tenancies Act that were designed to replace the Landlord and Tenant Act have not been proclaimed, as they are the subject of a constitutional challenge in the Supreme Court of Canada.)

Second, the Residential Tenancies Act requires whole building review for the increase of rents; that is, a landlord must apply for a simultaneous determination of rents for all residential units in the same building or

complex. The commissioner who determines the allowable rent increase then apportions it among the individual units. In doing this, he takes into account variations in rents in the building and variations in rents in similar buildings in the same area. The aim of this provision is to rationalize rents in the building and to undo inequities that were frozen in when rent control was imposed.[2]

Third, a tenant may apply for review of a proposed rent increase of 6 per cent or less (such a review applies to only the one unit). In making his decision, the commissioner may consider both changes in the standard of maintenance and variations in rents in the same building or in similar buildings in the area; he may not take into account the landlord's costs. This provision is to ensure fairness and to protect the landlord's right to receive the guideline increase even when his costs have risen by less than 6 per cent.

Finally, the act applies controls to the unit and not to the tenant. Thus a landlord cannot raise the rent on a unit because it has fallen vacant.

Accounting aspects of the act

While the basic features of the Residential Tenancies Act are simple, certain of its details are complex, especially those related to the computation of the landlord's costs and his rate of return.

The accounting information needed by the commissioner for his rent determination is provided by the landlord in a cost-revenue statement. It must include actual data for annual periods designated Year 2 (the most recently completed annual accounting period) and Year 1 (the annual accounting period preceding Year 2), as well as estimated data for a projected year (the accounting period beginning immediately after Year 2).

The landlord is required to set out his total net unit basic revenue, which is defined as the total rent that he would have received in Year 2 if all units had been rented, less the rent attributable to vacant units. Revenues derived from services for which a separate charge is levied (for example, parking) are detailed separately. The landlord also has to pro-

2 For example, if a landlord has raised rents between tenancies, rents for comparable units in the same building may vary substantially.

vide a detailed list of increases in operating costs attributable to residential units in the building, setting apart those related to services for which a separate charge is made. Residential operating costs are defined to include management and administrative overhead, payments for insurance, utilities, municipal taxes, maintenance, depreciation on capital expenditures undertaken part way through Year 1, and interest payments on loans for operating purposes.

For capital expenditures related to work completed in Year 2 or proposed to be completed in the projected year, justifiable costs include a write-off related to the estimated useful life of the improvement, interest paid on borrowed funds, and imputed interest on equity financing.

Increases in interest and principal payments resulting from renegotiated (at-arm's-length) mortgages can, in some circumstances, be passed through.[3] On the other hand, when financing payments cease because of the discharge of a mortgage, a commissioner will not normally offset this decrease against increases in other expenses. Increases in financing costs arising from the purchase of a property can be passed through only to the extent necessary to prevent a financial loss to the purchaser.

A 'margin adjustment' is also made to take into account the amount by which actual costs experienced in a period differed from costs projected for that period in a previous application for rent review.

The unit basic rent increase (ignoring, for the moment, the hardship provision) is expressed as a percentage. It is defined as the total increase in costs, experienced and/or anticipated (taking into account the margin adjustment), that are allowed by the commissioner at his discretion, less any decreases, divided by net unit basic revenue, all times one hundred.

3 The criteria used to determine in what circumstances increases in interest and principal repayments can be passed through are complex but logical. Generally, increases in interest payments are permitted when they result from an increase in the mortgage rate but not when they are due to an increase in principal (except that, when funds were reinvested in the building for an improving capital expenditure, the interest payment might be considered as part of a capital expenditure). Increases in principal repayments are not permitted when they have resulted from a shortening of the amortization period. Increases in financing costs arising from acquisition may be allowed only to the extent necessary to prevent a financial loss by the landlord.

The landlord's rate of return, computed for the purpose of applying the hardship provision, is defined as total revenue less 'out-of-pocket' expenses (our term), all divided by out-of-pocket expenses and then multiplied by one hundred. Out-of-pocket expenses include mortgage principal and interest payments, interest payments on funds borrowed to undertake capital expenditures, and operating costs (defined earlier) less depreciation. The hardship allowance (our term) is defined as the increase in revenues required to bring the rate of return, so computed, to 2 per cent, if this is positive; otherwise, the allowance is zero.

A summary of this calculation of the unit basic rent increase is given in Table 1.[4] A similar computation determines the permissible increase in the amount a landlord can charge for services for which a separate charge is levied. Adjustments are made for any changes provided and/or the method of charging for them.

While the details of this accounting procedure are complex, the guiding principles underlying them are clear. The accounting definition of cost, for all purposes except computation of the hardship allowance, is intended to approximate, as closely as possible, opportunity or economic cost. With respect to the hardship allowance, costs are defined so that the landlord will not face a cash-flow crisis as a result of rent control. The procedure is consistent, but, as will be noted later, there are systematic and troublesome divergences between accounting costs and economic costs.

ADMINISTRATIVE IMPLEMENTATION

This section treats the formal mechanics of the administration of the Residential Tenancies Act only cursorily. The emphasis is on how rent review in Ontario has been administered in practice.

The present act is administered by the Residential Tenancy Commission, which is governed by a board of commissioners; the chief tenancy commissioner acts as chairman of the board and chief administrative officer. Some commissioners are appeal commissioners, other sit on the board, and the rest operate out of regional offices.

4 For an explanation of how Year 2 and projected year capital expenditures are integrated, the reader is referred to the most recent edition of Guide to the Cost-Revenue Statement.

TABLE 1

Computation of unit basic rent increase in Ontario

1	Increase (decrease) in the allowable operating costs (excluding those related to the provision of services for which separate charges are levied).	_____
2	Increase (decrease) in annual write-off of allowable capital expenditures (major repairs and replacements and major renovations and improvements).	_____
3	Increase (decrease) in interest on borrowed funds used to make major renovations and improvements and deemed interest on equity financing for the same purpose.	_____
4	Increase (decrease) in allowable financing payments (mortgage interest and principal).	_____
5	Margin adjustment.	_____
6	Hardship allowance.	_____
7	Total allowable increases (sum of 1 through 6).	_____
8	Total net unit basic revenue.	_____
9	Unit basic rent increase as a percentage (7 divided by 8 times 100).	_____

Each rent review hearing is chaired by a commissioner, who, upon its conclusion, makes an order binding on landlord and tenant. A commissioner's order may be appealed to a panel composed of two appeal commissioners and one member of the board of commissioners, none of whom took part in the making of the original order. The panel is empowered to affirm the commissioner's decision or to substitute for it any other order a commissioner is authorized to make.

Rent determination hearings are conducted as informally as possible, although a commissioner has powers under the Public Inquiries Act (1977) to administer oaths and take sworn evidence. The formalities having been satisfied, the landlord discusses his cost-revenue statement, after which the commissioner and tenants question the statement. The commissioner then makes his determination and draws up his order. If the order is appealed, the commissioner prepares a written explanation of the reasons

for his order and forwards it to all parties to the appeal; they must then file statements setting out which findings they dispute. Uncontested findings are deemed true. At the appeal hearing, the parties are limited to presenting evidence on the issues raised by their statements.

These procedures have been designed so that the rent determination process may be simple and informal, yet fair and nonarbitrary.

The administration of rent control in practice

Whether the rent determination process is in fact fair depends on how it has been administered in practice. A number of questions come to mind:

- Has the rent review administration been diligent in informing tenants of their rights?
- Has the administration actively policed illegal rent increases, or has it been completely reactive, bestirring itself only when tenants complain?
- On what basis may the tenant dispute the contents of the cost-revenue statement? For example, is he given access to the landlord's books, or is he permitted access to only the aggregate financial data presented in the statement.
- Are the landlord and tenants on an equal footing at the hearings?
- How much discretion have the commissioners (or previously the rent review officers) actually exercised? Where they have permitted only partial cost pass-through or only part of a hardship allowance, what have been their reasons?
- Have commissioners been consistent in their orders?

Unfortunately, the evidence relating to these questions is fragmentary, and so the following attempt to answer them should be viewed as tentative.

An important general point is that the government has provided a bare minimum of funds for the administration of rent review. The annual budget of the Residential Tenancies Commission (and the old Rent Review Office) has fluctuated between $5 million and $10 million. This amount must cover all the administrative activity of the central and regional offices. It is moot whether this parsimony is due to a government effort

to cut costs or, as some critics have claimed, to an effort to take the teeth out of rent review.[5] Whichever is the case, the small budget has greatly restricted the scope of action of the rent review administration. Given their means, the administrators have performed admirably. Their interpretation of the acts has, by and large, been clear and sensible, and through the use of information bulletins and the like, they have been generally successful in obtaining consistency among the officers and commissioners. However, there is much that they have not done. First, they have not been diligent in informing tenants of their rights.[6] Second, they have made no attempt to track down illegal rent increases; worse, when they have come across them, they have usually not prosecuted. Third, data on the pattern of rent increases in Ontario have been collected by the Ministry of Housing rather than by the administrators of rent review; meanwhile the few available data on the outcome of rent determination hearings have been collected solely for internal administrative purposes.[7] The results provide little insight into the reality of rent deter-

5 This view is put forward by Whitelaw (1979). He also argues that several accounting tricks allow costs to be amortized over a shorter period of time than they should be on the basis of economic criteria. One obvious trick is to arrange a very short-term mortgage upon the purchase of a building. Another is to make improvements whose economic length of life is greater than the corresponding accounting length of life.

6 Nevertheless, tenants seem to be reasonably well aware of them. This conclusion is supported by a study carried out by the Housing Committee of the Social Planning Council of Ottawa-Carleton (1978).

7 These data relate to the administration of the program and treat only those rental units that entered the rent review process. A major difficulty is that no data are available comparing what landlords felt they deserved on the basis of increased costs and what they were actually allowed. The data for 1976 make no distinction between the outcome of transitional (i.e., retroactive) and post-transitional hearings. In the data for 1977, the results of hearings held when the guideline was 8 per cent are not distinguished from the results of hearings held when the guideline was 6 per cent. It is worth noting that only a relatively small number of rental units entered the rent review process. Rents of 131,455 units were considered in 1976 (hearings in 1976 covered a seventeen-month period of controls, including the five-month retroactive period). This constitutes 10 to 20 per cent of Ontario's rental housing units, probably closer to 10 per cent. Rent determination hearings held in 1977 involved 35,648 units. In 1976, landlords sought an average increase of 19.66 per cent, but only 12.56 per cent was permitted (raised, on appeal, to 12.60 per cent). In 1977, landlords sought an average increase of 18.09 per cent and were permitted 12.17 per cent (this figure remained unchanged on appeal).

mination. Fourth, the rent review administration has undertaken no research to determine, for example, how rent review is perceived by the public or how it might be improved.

A second general point is that both the formal mechanics and the informal implementation of rent determination give the landlord an advantage over the tenant. The typical tenant is familiar with only the repair and maintenance for his own unit and for the public areas of his building. Thus he is hard put to evaluate the fairness or accuracy of the cost-revenue statement, the only cost data he is granted access to. (For instance, it is not likely that a tenant would know if the stated costs included sizable expenditures on the landlord's unit.) Also, the format of the rent determination hearings appears to give the landlord a psychological advantage (Housing Committee of the Social Planning Council of Ottawa-Carleton, 1978).

In summation, while the broad outlines of the rent determination process are well-conceived, its administrative implementation and some of its formal details leave a lot to be desired.

SUGGESTED MODIFICATIONS TO THE RENT CONTROL PROGRAM

It is not our intention to comment on the desirability of either rent control in general or the form of controls employed in Ontario; these issues are treated in Chapter 6. Instead, we wish to suggest a few minor changes to the existing legislation and its implementation. Since most of our efforts in preparing this study were devoted to considering the desirability of the continuation of controls and the pros and cons of alternative decontrol mechanisms, the suggestions here should be viewed as ideas worthy of consideration rather than as strong recommendations.

- The funding of the Residential Tenancies Commission should be increased. To administer the act effectively, the commission requires a sizable increase in its budget.

- The Residential Tenancies Commission should actively police and aggressively prosecute illegal rent increases. Those who abide by the law should never suffer for doing so. Yet given the commission's current passivity, this is what is happening. Moreover, the victims of illegal increases are the poor and the uneducated; educated tenants know their rights and are eager to exercise them.

- The Residential Tenancies Commission should more actively inform tenants of their rights. Again, the victims of the commission's passivity are the uneducated.

- The Residential Tenancies Commission should devote more resources to data collection and research. Data are needed both for external review of the rent control program and, internally, for identifying problem areas allocating resources efficiently.

- The Commission should reconsider the current procedures for determining cost increases. We see four basic problems in this area. First, if a landlord's accounting cost diverges significantly from his economic cost, cost pass-through will yield both inequities and inefficiencies.[8] Use of straight economic cost could create cash-flow problems for landlords, but it should be possible to revise the measurement of accounting cost to bring it closer into line with economic cost without causing serious problems of this sort. Second, the current rent determination procedure provides landlords with an incentive to have a fluctuating annual cost stream.[9] To eliminate

8 Inequities arise because two landlords with the same economic-cost increase may have different accounting-cost increases and consequently (via cost pass-through) different rent increases. Inefficiences because efficiency requires that, for a given level of revenue, landlords should minimize economic cost. But if rent increases are based on accounting costs, landlords will minimize some weighted average of economic and accounting cost; this leads to inefficiencies when accounting cost diverges from economic cost. For example, if interest and principal payments on capital expenditures do not coincide with true economic depreciation, a landlord will undertake such expenditures earlier or later than is efficient. Moreover, the determination of cost increases is not adjusted for inflation, and this omission is likely to widen the difference between economic and accounting cost.

9 This suggests an obvious potential abuse. By including projected year costs in his cost-revenue statement, a landlord can get a rent increase on the basis of anticipated expenditures. If he does not undertake these expenditures and does not return for rent review in the next three years, he can easily get away with an illegal rent increase.

Another potential abuse is perfectly legal. Under a guideline increase/cost pass-through scheme, a landlord has a clear incentive to have an unstable cost stream. He can increase his costs every third year, obtain a sizable rent increase via cost pass-through, then lower his costs and accept the guideline increase in each of the next two years. This pattern would not be captured on the cost-revenue statement, which looks back only two years. However, should the tenants complain about such a pattern at a rent review hearing, a landlord would get away with this trick only once (see Chapter 4, note 14).

Because so few data are available, we are unable to estimate the extent of these and other abuses.

this problem, it might be worthwhile to compute cost increases as a weighted average of past costs for the purpose of cost pass-through.[10] Third, the present treatment of mortgage payments is highly problematical and merits rethinking.[11] Fourth, the use of estimated costs for a projected year is open to abuse.[12] The use of only Year 1 and Year 2 costs should be considered even though it would result in the postponement of cost recovery.

- The Commission should rethink the way in which the hardship allowance is computed. We do not dispute the desirability of a hardship allowance: one does not want controls to cause abandonment. Yet the way in which the hardship allowance is currently computed is inequitable, leads to inefficiences, and is open to abuse.[13] If these problems can be eliminated, the allowance should probably be increased.

10 Note that since current weighted average costs are a weighted average of prior period weighted average costs and current costs, no more financial information would be needed in rent determination than is needed at present. This system would, however, result in part of a landlord's recovery of cost increases being postponed.

11 All kinds of inequities arise from the current treatment of mortgages. Consider two landlords who own identical buildings: one has an 80 per cent first mortgage, the other owns his building outright. Now, suppose the interest rate increases. The first landlord, upon renegotiating his mortgage, is able to pass the increase in his mortgage payments through. The second gets no relief, even though the opportunity cost of the funds he has invested in the building has increased. There are also real problems in deciding what mortgage payment increases should be allowed upon the sale of a building.

12 This problem is discussed in note 9.

13 Consider a landlord who owned a building outright when controls were imposed and has been receiving a rate of return (computed as in the hardship provision) of somewhat over 2 per cent. Now he sells the building. The new owner is allowed to treat his principal and interest payments as a cost, and this pushes his rate of return below 2 per cent. He gets a hardship allowance, whereas the former owner did not, even though their economic circumstances were the same. This kind of inequity encourages the sale of buildings with small mortgages.

Notice, too, that the new owner gets a dollar-for-dollar increase in rent for an increase in mortgage payments. Thus he has an incentive to lever himself to the maximum extent allowable, which may be inefficient (for example, it may lead to excessive risk-taking). He also has an incentive to put capital expenditures forward, if this will make him eligible for the hardship allowance.

Moreover, the hardship provision encourages the landlord to have a fluctuating annual cost stream. If he obtains annual rates of return (as computed for the hardship provision) of 3 per cent, 3 per cent..., he will receive no hardship allowance. However, if he adjusts his cost stream to get annual rates of return of 6 per cent, 6

- Reconsideration should be given to that section of the act, as yet unproclaimed,[14] under which the rent determination process would take into account changes in the quality of services provided. If this provision could be equitably enforced, then the efficiency loss associated with the undermaintenance that rent control causes would probably be reduced.[15] But it is also probable that its implementation would result in inequities that exceeded any efficiency gain.[16] Moreover, the introduction of subjective elements into the rent determination process might substantially increase the appeal rate and, hence, administrative costs.

- Reconsideration should be given to the desirability of rationalizing rents in a building on the basis of the pattern of rents in the neighbourhood. At the time controls are imposed, rents for similar units will vary.[17] Some provision for the rationalization of rents is therefore desir-

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per cent, 6 per cent, -6 per cent, 6 per cent..., he will receive a sizable hardship allowance every fourth year. This loophole too could be blocked if a moving average of costs were employed.

14 See note 1.

15 This is explained in Chapter 3. On the other hand, it may be efficient for the landlord to spend less and less on maintenance on his building over time. In these circumstances, a provision that had the effect of inducing him to keep maintenance expenditures constant over time might be inefficient.

16 The problem with basing rent increases on the quality of services is that this is very difficult to measure or monitor. For instance, due to a very heavy snowfall, the entrance to an apartment building is not kept free from ice, as it was the winter before. Has the quality of service fallen, even though snow removal costs have risen? Similarly, the lawn may be mowed more frequently in a wet summer than in a dry one, but still be untidy. Another problem is that certain services are intermittent. It may be standard practice, for instance, to paint hallways every five years and clean outside windows every two. Has the quality of service fallen in a year in which neither of these activities is undertaken? If the landlord installs new kitchen stoves that, unknown to him at the time of purchse, tend to break down more frequently than the old stoves, has the quality of service fallen?

17 One should not expect rents in a competitive housing market to be the same for identical units. Tenants differ markedly in how well they look after their apartments and how considerate they are of their neighbours. It is economically rational for a landlord to charge a higher rent to an inconsiderate, careless, and destructive tenant. Moreover, tenant turnover is costly. Charging the tenant an exit fee to cover the expected costs of finding a new tenant is illegal (for obvious reasons - if this were allowed, landlords would have an incentive to set the fee above turnover cost and harass tenants), but the landlord may lock in his tenants by charging less to those tenants who have been in the building longer. Finally, rents may vary with the length of leases.

able. However, basing rationalization on the pattern of rents 'for similar units in complexes located in the same geographical vicinity' (Ontario 1979c, s. 131(4)) introduces an element of subjectivity into the rent determination process.[18] This could lead to substantial increases in administrative costs, as well as to greater inequities than would follow from simply basing rationalization on the historical pattern of rents in the building under consideration.

- Both the mechanics of rent review and the format of review hearings should be modified to put tenants on an equal footing with landlords. The problem here is a knotty one. The landlord has a strong incentive to devote a lot of time and effort to the preparation of his case. However, while the tenants of a building together stand to gain substantially from keeping the rent increase small, no single tenant stands to gain enough to warrant his spending a lot of time scrutinizing the landlord's case. There is also the free rider problem. What is needed is an institutional structure that would give the tenants of a building the incentive to prepare a thoughtful argument against their landlord's case. One possibility is to require the landlord to give his tenants a per unit allowance (which he could deduct as a cost) for hiring an accountant who would have access to the landlord's books and would prepare a case on the tenants' behalf.

Despite our fairly wide-ranging suggestions for modifications to the act and its administration, we feel that the details of the present law and its application are generally sensible, taking as given the chosen mode of control. By and large, a judicious balance has been struck between administrative simplicity, equity, and adherence to the intent of the legislation. The informality of the rent determination process is most

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Moreover, a number of rental contracts are not arm's-length transactions. For instance, a widow may buy a large house and have some of her friends live in other apartments in the building at below-market rents. Furthermore, discrimination in the housing market can cause rent differentials.

18 Location rents often differ markedly over very short distances. Units in an apartment block on a lake, on top of a hill with an unobstructed view, or near a subway station may command considerably higher rents than physically identical units a couple of streets away. Furthermore, the premium for apartments on higher floors may be larger in buildings with a view. How, then, is one to decide which units in the same geographical vicinity are similar?

welcome. The review hearings not only eliminate wasteful legal expenses but put the poor and poorly informed tenant at less of a disadvantage than would a court of law. Furthermore, the accounting procedures developed for the purpose of rent determination are clear, consistent, and workable, if not ideal.

3
The effects of rent control: the existing literature

Economists have made little progress in analysing the effects of rent control. This failure is due to three factors: the peculiarities of the housing market, the difficulty of treating any sort of market characterized by excess demand, and the complexity of most rent control programs. What sound analysis does exist tends to treat rent control in general terms, ignoring the specifics of individual programs. Popular discussions of rent control usually provide a black-and-white argument pro or con, again with little regard to particular control programs. Yet it is apparent - as this study will emphasize - that different rent control programs have markedly different effects. Thus a satisfactory discussion of the effects of Ontario's program requires a more sophisticated framework of analysis than has hitherto been employed. Chapter 4 will attempt to provide just such a framework. The task of the present chapter is to review the more tendentious arguments for and against controls and, as well, to examine the limitations of the existing technical literature on controls.

ARGUMENTS AGAINST RENT CONTROL - A CRITICAL SUMMARY

The literature opposing rent control, most of it the work of conservative economists, generally presents variants of the familiar invisible hand argument in favour of the free market and against government intervention.[1] The cornerstone of modern microeconomic analysis is the theory

1 Examples of this literature are collected in The Fraser Institute (1975).

of competitive equilibrium, which yields the proposition that a competitive economy, unfettered by government intervention, is efficient. Given such an economy, and given an individualistic social welfare function, social welfare is maximized when the only form of government intervention is the lump sum redistribution of income.[2] The essential property of an 'individualistic social welfare function' is that it respects consumer sovereignty. It assumes that an individual is better off if he alone chooses how to spend a given sum of money on himself, even if he uses it to buy alcohol, drugs, or an acre of Florida swampland that was advertised as a vacation paradise. Income redistribution is 'lump sum' when the government determines how much to give a recipient on the basis of his intrinsic characteristics, rather than on the basis of his actions. Yet the validity of the assumptions implicit in the terms 'competitive economy', 'individualistic social welfare function', and 'lump-sum redistributive' is by no means beyond dispute.

When an economist describes an economy as 'competitive', he uses the word in a strict sense. An economy or market can be said to be competitive only if three conditions are present:

- no economic agent or group of agents can influence prices;
- all agents are equally well-informed;
- transactions costs are negligible.

It is evident that the housing market is far from a perfect competitive market. First, most advocates of rent control believe that landlords influence rents, and in fact they do have some monopoly power. Second, all agents are not equally well informed. Landlords can judge only imperfectly who will be a good tenant; tenants do not know the quality of maintenance in the building when they sign the lease; bankers can only estimate the credit-worthiness of prospective mortgage and construction borrowers. Third, transactions costs - in this context, moving and search costs - are significant. It is also possible to demonstrate the uncompetitiveness of the housing market by describing how a competitive housing market would work. In such a market, a tenant could choose a new apart-

2 These propositions have been eloquently expounded by Milton Friedman (1980).

ment to sleep in every night and move his belongings without cost. He would know the characteristics of all housing units in the market and could purchase full insurance against any eventuality.

Lump-sum redistribution is efficient only when the government respects consumer sovereignty, which in many ways it does not. It uses laws and taxes to discourage prostitution, drug-taking, gambling, and the consumption of alcohol and tobacco, and it uses subsidies to encourage the arts and the consumption of food and housing by the poor. Lump-sum redistribution is usually infeasible in any case, since the government cannot observe all of a given individual's intrinsic characteristics. To some extent at least, it must base its taxes on the individual's actions.

Because the invisible hand argument rests on a series of questionable assumptions, it is unpersuasive a priori. However, the housing market may be 'nearly' competitive, in which case the invisible hand argument would provide a good guide to policy. But to establish this requires a more sophisticated and empirical argument.

While the doctrinaire conservative argument against rent control and other forms of government intervention is unconvincing, there are sound economic arguments against rent control that would be supported by most economists. The common theme of these arguments is as follows. Our economy does differ in important ways from a perfectly competitive economy. As a result, government intervention in the right form can improve social welfare. Rent control, however, is a very clumsy way to correct housing market imperfections and to achieve other housing market goals.

A good rule of thumb is that an efficient policy for achieving a given goal aims directly at that goal. For example, if the government wants to discourage the consumption of bananas, it is more efficient to tax bananas than to subsidize apples. Indirect policies usually have undesirable side effects. If the government's aim is to improve the housing of the poor, the efficient policy is to reduce the price that the poor, but not the rich, have to pay for housing of a given quality, without removing the landlords' incentive to maintain their properties. These ends can be achieved by an income-related rent subsidy. Rent control, however, affects not only the rent the poor have to pay for housing of a given quality, but also the rent the rich have to pay and the rent landlords receive. Given the aim of the policy, the latter two effects are undesirable. The rich,

facing rents below the scarcity value of housing, demand more housing than is socially optimal, while landlords, receiving a return on housing below its social value, spend less on maintenance and construction than is socially optimal. Similarly, if the government's goal is to ensure tenant security and to prevent unconscionable rent increases, then it should provide some sort of appeal procedure for tenants burdened with intolerable rents. Such an arrangement would be distinct from true rent control, which regulates not only unconscionable rent increases but also justifiable ones.

The harmful side effects of rent control have been extensively discussed. The best understood is the effect controls have on housing maintenance. At every point in time, the rational landlord undertakes maintenance up to the point at which the last dollar spent on maintenance causes the value of the property to increase by one dollar. All known forms of rent control, however, result in each dollar of maintenance increasing the value of the property by less than it would have increased without controls. Thus controls cause landlords to cut maintenance expenditures. Consider an extreme case in which the rent on a housing unit is fixed substantially below the market-clearing rent. Because there is considerable excess demand, the landlord can rent his apartment even if he spends nothing on maintenance. The profit-maximizing maintenance expenditure in this example may be zero. While the argument that rent control causes a reduction in maintenance has not been persuasively formalized, its empirical validity is compelling.[3]

It is also claimed that rent control creates a price ceiling below the market-clearing price, causing excess demand. One effect of this is reduced mobility. A tenant is discouraged from moving within the local rent-controlled housing market because the search costs of finding a preferable unit are high when there is excess demand. And he is discouraged from moving to a jurisdiction without rent control because he would have to pay more for comparable housing. This creates inefficiency in the labour market. Reduced mobility also results in a mismatching of households to housing units. Elderly couples and widows occupy units

3 A graphic example of the decline of maintenance under rent control is provided by New York City's moribund housing stock. New York's rent control experience is described in Appendix C.

that were of the appropriate size when their children were at home but that are now larger than the units they would choose in an uncontrolled market. Meanwhile, a large family moving into the rent-controlled jurisdiction may have to settle for cramped quarters, even though it would be willing to pay more than the controlled rent for a larger apartment. This mismatching creates horizontal inequities: households that are substantially identical may have to pay different amounts for comparable housing, or may not be able to find comparable housing. Furthermore, these inequities are systematic rather than random, favouring long-time residents and encouraging discrimination.[4] Finally, excess demand gives landlords an incentive to circumvent controls - by demanding key money, for example.[5] While rent control need not cause excess demand, since landlords may cut back maintenance enough to make the controlled rent equal the market-clearing rent, the experience of those who have lived in rent-controlled housing markets indicates that excess demand usually does occur in them.

A third class of claimed deleterious effects of rent control relates to the volume of new housing construction. When controls are introduced, the government usually announces that rental housing constructed after their imposition will be exempt. This is done in order not to discourage new rental housing construction. However, there have been enough cases of governments reversing this policy to make landlords justifiably wary. Builders confronted by controls may adopt a wait-and-see attitude, postponing new construction until they are persuaded of the government's good faith. Controls may also alter the profitability of rental housing construction and affect the volume of owner-occupied housing construction. In the latter case, however, the effects may offset each other (see Gould and Henry, 1967). On the one hand, by making rental accommodation cheaper, rent control may reduce the demand for owner-occupied housing. On the other hand, excess demand for rent-controlled housing may spill over into the owner-occupied housing market, driving prices upward and

4 All other things being equal, in a housing market free of excess demand, a landlord who practices discrimination will probably receive lower profits than a landlord who does not. In a market with excess demand, however, a landlord can discriminate in his choice of tenants with no reduction in revenue.

5 Key money is a 'deposit' payable when a tenant moves into an apartment and rarely refunded when he vacates.

stimulating more construction. Moreover, rent control may induce such rapid deterioration in rental housing that, when quality is taken into account, real rents for controlled housing will be found to have risen, and this too may encourage the construction of owner-occupied housing.

It has also been suggested that rent control encourages tenure conversion from rental to owner-occupied status.[6] Because the costs of moving are higher for an owner-occupant than for a renter, tenure conversion reduces mobility. Moreover, because of down-payment requirements, young families may be forced to settle for housing inferior to the housing they would rent in an uncontrolled market.

The cogency of these qualitative arguments depends on their quantitative importance. This has two dimensions, the magnitude of the efficiency loss associated with controls and the extent and direction of the redistribution caused by controls. These in turn depend on the nature, duration, and extent of the control program.

The concept of an efficiency loss associated with rent control or any other form of government intervention is somewhat elusive, since efficiency losses are, by their nature, invisible. Because they do not show up on balance sheets, they are apt to be discounted, yet from an economic point of view they are as real as financial losses or the physical destruction of resources. Consider the effect of a rent control program applied to a small, open jurisdiction, in which landlords respond to the controls by running down their housing so rapidly that there is no excess demand. In this case, the market-clearing rent never exceeds the controlled rent. Since the jurisdiction is small, renters can choose to live in either the rent-controlled jurisdiction or neighbouring uncontrolled jurisdictions. As a result, at any level of housing quality, the market-clearing rent in the controlled jurisdiction is the same as that in the uncontrolled jurisdictions. The controls neither help nor hurt residents of the controlled jursidiction, since they pay the same rent for a housing unit of a given quality as they would in the absence of controls. The controls do, however, affect land-

6 If there were perfect capital markets and no restrictions on tenure conversion, rent control would have no effect. All rental housing would be instantaneously converted to owner-occupancy status. Thus a satisfactory analysis of the tenure conversion induced by rent control would have to consider the nature of capital market imperfections (about which economists know little) and the restrictions on tenure conversion that are often part of a rent control package.

lords. In particular, rent control reduces the profitability of their buildings and thus lowers their market value. In this very simple scenario, the gainers and losers and the efficiency loss associated with controls are readily identifiable. Tenants neither gain nor lose, landlords in the controlled jurisdiction lose by an amount equal to the reduction in the present value of their profits or, equivalently, the fall in value of their property, and other sectors neither gain nor lose.[7] Thus the efficiency loss, which is the sum of the dollar gains and losses incurred through controls throughout the population, is measured by the fall in the market value of rent-controlled property.

When the controlled jurisdiction is large or when rent control causes excess demand, the efficiency losses associated with controls become far more complex. Landlords still lose by an amount equal to the fall in the value of their property, but now some tenants lose and some tenants gain. Ignoring the quality dimension for the moment, consider two apartments, one large, one small, and two renters, a widow and a large family. Because of rent control, the widow lives in the large apartment and the family in the small one. The widow pays $300 per month for her apartment and would be as well off if she lived in the small apartment and paid $200 per month. The family pays $225 per month for its small apartment and would be as well off if it lived in the large apartment and paid $550 per month. In the absence of controls, the rent on the small apartment would be $300 per month and on the large apartment $500 per month. Who gains, who loses, and what is the efficiency loss? First, the landlord loses $275 per month. Second, the widow gains $100 per month. In an uncontrolled market, she would live in the small apartment and pay $300 per month, but now she is as well off as she would be if she lived in that apartment at $200 per month. Finally, the family loses $50 per month. In an uncontrolled market, it would live in the large apartment and pay $500 per month, but now it is only as well off as it would be if it live in that

7 As a result of controls, resources that were used in rental-housing maintenance are released to other sectors. But since we have assumed that these other sectors are operating efficiently, and since controls are applied in only a small jurisdiction, the social and private cost to these sectors of the additional resources acquired just equals the social and private benefits. Thus to discover the efficiency loss caused by controls, one need only look at the net loss to economic agents in the controlled jurisdiction.

apartment and paid $550 per month. Thus the efficiency loss is $225, and it all stems from the mismatching associated with the change in the structure of rents induced by rent control. (It should be noted that the efficiency loss associated with such mismatching in a rent-controlled housing market with excess demand depends on the rationing scheme employed.)

No one has ever tried to measure or even closely estimate the efficiency loss associated with a rent control program. Nevertheless, it is clear that anyone who did try would have to bear three points in mind. First, the efficiency loss depends very much on the details of the rent control program, including the allowable rent increase, the extent to which cost pass-through is permitted, the program's duration, the form of rationing employed, and the treatment of newly constructed housing. Second, it is a rule of thumb that the magnitude of the annual efficiency loss varies approximately as the square of the size of the distortion.[8] While it is not precisely clear what the 'size of the distortion' means in the context of rent control, the rule suggests that the annual efficiency loss associated with controls increases more than proportionally to the length of time that controls are applied. (Thus one should not conclude that controls are harmless if during the first few years of their application the inefficiencies associated with them appear minor.) Finally, a point made earlier bears repeating: that rent control imposes no financial cost on the government does not mean that it is costless. Its invisible costs may be very high.

The distributional effects of controls are crucially important but very difficult to ascertain. The problems associated with determining them are treated later in the chapter. However, one such problem was touched on in the previous discussion: among tenants, gains and losses from rent control are determined in part by the rationing scheme used to allocate excess-demanded housing.[9]

8 For example, the efficiency loss associated with setting the price of bread ten cents below the market-clearing price is approximately four times that associated with setting it five cents below it. For the derivation of the rule and qualifications concerning its generality, see Atkinson and Stiglitz (1980, lecture 12).

9 For instance, the poor benefit from a first-come-first-served rationing mechanism, but not from one that gives higher priority to those with higher incomes.

Another argument against rent control is political rather than economic. Those who stand to lose the most from decontrol are those who have the bargain rent-controlled apartments, and these are generally long-term residents with a larger share of political power than their numbers justify. Furthermore, decontrol causes redistribution from tenants to landlords, which is likely to be politically unpopular. Finally, because the gains from decontrol are invisible, they are usually underestimated by the voting public. For all these reasons, once controls are imposed, they are usually very difficult to remove. Thus even if rent control would be a wise policy for a period of, say, five years, it might be better not to introduce it at all.

A final objection to controls recalls the old lady who swallowed a spider. Rent control is introduced, and legislators observe that the quality of maintenance falls and the property tax base shrinks. Diagnosing these problems incorrectly, they introduce maintenance standards as an eligibility requirement for cost pass-through, impose stricter builder codes, and raise property taxes. This makes many buildings unprofitable, so landlords abandon them. Thus rent control may give rise to housing legislation that is at least as harmful as rent control itself.

ARGUMENTS FOR RENT CONTROL - A CRITICAL SUMMARY

The popular arguments in favour of rent control are based on misconceptions about the way the housing market works.

In one popular view, the landlord is a rapacious exploiter of the defenceless tenant. This argument, at least in its crude form, is untenable. While there are many noncompetitive aspects of the housing market, barriers to entry are small. If landlords were indeed victimizing tenants, then a new entrant to the housing market would be able to make a sizable profit by constructing new rental housing units and undercutting the monopoly rents charged by other landlords; to keep their tenants, the latter would be forced to lower their rents. This adjustment process would continue until marginal landlords were making zero economic profits. In reality, high rents reflect scarcity and high costs far more than they reflect the monopoly power exercised by landlords as a group. It is true, however, that landlords do have some degree of monopoly power. Because

of the heterogeneity of housing units and the costs of moving, landlords can raise rents without causing a mass exodus of tenants, and certainly landlords sometimes do take unfair advantage of their monopoly power. For example, an unscrupulous landlord might raise the rent on an apartment occupied by an invalid old lady, for whom moving costs would be very high, to an unconscionable level. But such cases are probably rare, and they can be dealt with far more efficiently by providing an informal process of appeal against unconscionable rent increases than by the imposition of rent control, which is a very clumsy means of ensuring tenant security. In any case, rent control cannot police monopoly power that has been exploited before controls are implemented.

Another popular argument in favour of controls is that they ensure affordable and decent housing for all. To see this argument in its starkest form, imagine that the government were to legislate the provision of all housing free of charge. In the short run, with the stock of housing fixed, there would be a huge excess demand for housing. The allocation of good housing and bad would depend on the rationing schemes employed by individual landlords, and there would be little reason to trust their benevolence. Moreover, landlords would have no economic incentive to maintain their housing or to construct new housing; as time passed, the housing stock would become more and more dilapidated, until everyone would be living in substandard housing. Thus even if controls do improve the housing of the poor in the short run, it is very doubtful that they provide an efficient means to this end. The argument fails to realize the implications of a rent being not only the price paid by the tenant but also the price received by the landlord. If government decree lowers rents, it lowers not only how much tenants have to pay but also how much landlords receive. In response to falls in their revenues, landlords will cut costs by cutting maintenance. If the government's aim is affordable and decent housing for all, it should lower the rent the tenant pays without reducing the rent the landlord receives. As we have already suggested, this can be achieved by a system of rent subsidies. Such a policy would be costly, but there are no free lunches.

A further common argument is that rent control causes redistribution from tenants to landlords. The argument is correct as far as it goes, but there are several cogent reasons why rent control is not an efficient way to redistribute wealth. First, redistribution through rent control should

not be confused with transfers from rich to poor. Landlords as a group are not necessarily much richer than tenants. In fact, if landlords subject to rent control ration excess-demanded housing on the basis of tenant income, then redistribution might occur from landlords to tenants who are richer than the landlords. Second, rent control has the unwanted side effect of inducing deterioration of housing. The efficiency loss may be so large that even though tenants are relative gainers, they are absolute losers. Finally, it is inequitable to single out landlords for economic punishment. According to commonly accepted views of social justice, redistribution should occur from all the rich to all the poor, and this is most effectively done by means of progressive taxation on income or wealth. On the other hand, rent control may be more acceptable politically than some other forms of redistribution. Most Canadians subscribe to what Tobin (1970) calls specific egalitarianism; they favour providing everyone with decent housing, food, and clothing but generally object to providing the poor with income, which might be spent 'irresponsibly'. Furthermore, the costs of rent control, as opposed to rent subsidies, are invisible. In addition, long-time tenants, who rent the majority of bargain apartments under rent control, and who usually have considerable political power, are likely to favour controls over other forms of redistribution. Finally, tenants outnumber landlords, which makes rent control attractive to politicians.

There are several less common and more technical arguments in favour of rent control. One is that rapid change is costly. The housing market is volatile, and because builders sometimes underestimate the strength of demand in the market, there will be periods when rents rise very rapidly. Builders will respond to this, and eventually rents will fall back to a 'normal' level.[10] But in the interim, many tenants will be forced to move. It may be less disruptive to impose rent control and smooth the price adjustment. Moreover, if the real cost of housing increases rapidly, as it did in the early 1970s because of rapidly rising labour, land, and construction materials costs, smoothing the increase in rents would give tenants who cannot afford the higher rents more time to find the cheaper apartments that suit their needs.

10 The 'normal' rent on housing at the quality levels at which construction occurs is the amortized replacement cost.

There is also a host of conceivable 'second-best' arguments in favour of controls. Broadly speaking, a second-best argument states that it may be desirable to introduce a distortion to offset another, larger one. For example, to offset excessive road congestion, it may be desirable to price public transportation below its marginal cost or even to provide it free. In the case of rent control, a possible second-best argument is that controls may offset excessively liberal tax laws that encourage landlords to spend too much on maintenance (so that the social value of the last dollar spent on maintenance is less than one dollar). It is hard, however, to think of a truly cogent second-best argument in favour of controls. While there are many distortions in the housing market, rent control is not usually the second-best means to offset them.

A SYNTHESIS

When Franz Kafka was debating whether or not to get married, he drew up a list of pros and cons; since the cons outnumbered the pros, he decided against it. For better or worse, such a procedure is not a sound one for evaluating social policy. A policy issue can rarely, if ever, be resolved in a wholly satisfactory way on the basis of a priori, qualitative reasoning alone. Rather, the pros and cons should be quantified to determine whether the dollar benefits of a given policy exceed its dollar costs. Unfortunately, the data are not available for even ballpark estimates of the dollar costs and benefits of a typical rent control program. Thus in order to evaluate the desirability of imposing or continuing rent control, the (second-) best that can be done is to employ qualitative reasoning, supplemented by whatever quantitative evidence is available, even if it is casual or impressionistic.

It is possible to establish several reasonable propositions on the basis of the qualitative arguments for and against rent control.

- Rent control is generally undesirable in a stable housing market. A stable housing market is one in which the real rent on a housing unit of standarized quality is changing only slowly. The basic argument is that in such a housing market, another policy can do anything that rent control can do - and do it better. If the aim is to prevent unconscionable rent increases, the efficient policy is to design procedures that allow tenants to

appeal such increases easily and at low cost. If the aim is to provide decent housing for the poor, then the government should employ rent subsidies. If the aim is redistribution, the tax system should be used to achieve it. Rent control is an indirect means to these ends, and usually the most efficient policy is the most direct one.

- A cogent argument can be made in favour of rent control in a highly unstable housing market. Because of the high costs to tenants of adjusting to rapid rent increases, it may be desirable in a highly unstable housing market to smooth rent increases. For example, four annual rent increases of 10 per cent are considerably less disruptive than a 40 per cent increase in the first year, followed by stationary rents during the next three. Rent control is the most direct policy to provide such a smoothing of rent increases. The return of soldiers after the Second World War caused a sudden increase in housing demand; this would have induced a very rapid and disruptive increase in rents had it not been for an almost universal application of rent control.

- The efficiency associated with rent control tends to increase as the square of the length of time during which they have been imposed. Efficiency loss increases approximately as the square of the size of the distortion. This argument is supported by the observation that those cities in which rent control is claimed to have had a devastating impact (for example, New York, Paris, Vienna, and Cairo) have all had controls for a long time.

- Even when it is desirable to impose controls, they should be temporary. It follows from the first two propositions above that rent control should be imposed only in response to some unusual set of circumstances that would otherwise cause a sudden and dramatic increase in rents. Because only exceptional circumstances can justify controls, the benefits associated with them tend to decrease the longer they are applied. On the other hand, the third proposition suggests that the efficiency costs associated with controls tend to increase over time. Taken together, these statements imply that there is some optimal period for the application of controls, after which decontrol measures should be instituted.

- The costs and benefits associated with rent control are sensitive to both the details of the rent control program and the characteristics of the housing market in question. This proposition follows from previous argu-

ment. It implies that it is pointless to debate in general terms such matters as the optimal duration of controls. Clearly, the optimal period depends on the specific characteristics of the housing market and rent control program in question.

- Because rent controls can, for political reasons, prove difficult to remove, it may be better not to introduce it at all.

To summarize: in a highly unstable housing market, it may be desirable to impose rent control. However, it should always be treated as temporary. How long controls should be applied depends on the nature of the control program and local housing-market conditions. If controls, once imposed, are likely to prove hard to remove, it is probably wise to avoid them.

TECHNICAL LITERATURE ON RENT CONTROL

The singular nature of the housing market makes it an unusually difficult one to treat. While it is imperative to have a manageable conceptualization of the housing market, it is no less important to avoid misleading oversimplification. Unfortunately, existing analyses of rent control are based on a model of the housing market that is excessively simplistic.

Characteristics of housing as a commodity

The principal characteristics that differentiate housing from most other commodities are spatial fixity, durability, heterogeneity, high transactions costs, and the pervasiveness of government intervention. Each is now discussed in turn:[11]

Spatial fixity

Unlike almost all other commodities, a housing unit cannot be moved from one location to another. As a result of spatial fixity, 'the' housing market is in fact a group of spatially segmented submarkets. The effects of a policy may vary among these submarkets.

11 This discussion draws on Rothenberg (1975).

Durability

Housing is the most durable of consumer goods. The ratio of new housing units constructed each year to the total stock of housing is usually on the order of only 2 or 3 per cent. Because housing is durable, the stock adjusts only slowly to policy changes. Thus the immediate effect of any policy is to alter prices rather than the composition of the housing stock. These induced changes in prices produce windfall gains for some groups and losses for others. For this reason, issues in housing market policy are very sensitive politically. Another result of housing's durability is that a housing market policy affects not only new housing construction but also the existing stock of housing, by encouraging or discouraging maintenance and demolition.

Heterogeneity

No two housing units are alike. This poses problems for the housing market analyst. Should he treat each housing unit as a different commodity? Or should he view each housing unit as a bundle of attributes and analyse the supply of and demand for these attributes? If the latter, then what attributes and how many of them should he treat?

High transaction costs

Economists use the term 'transactions costs' very broadly to include any costs incurred in acquiring a good in excess of its market price. In the context of the housing market, transactions costs include moving costs, the costs of acquiring information, and the costs of searching for a house. While the standard competitive analysis ignores transactions costs, they are high and very important in the housing market and are responsible for many of its peculiar institutions. If there were no transactions costs, there would be perfect information and perfect capital markets. There would be no real-estate agents since search costs would be zero. There would be no sharp distinction between rental and and owner-occupied housing. There would be no credit rationing and no down-payment requirement in the mortgage market. Nor would there be any moving costs. Economists have only begun to analyse transactions costs. To ignore them in the housing market is to assume a lot away.

Pervasiveness of government intervention

The government taxes, subsidizes, or regulates almost every aspect of economic behaviour in the housing market. Analysing the effects of a housing market policy in vacuo, ignoring the myriad of other government programs, may result in a seriously misleading analysis.

The standard model of the housing market

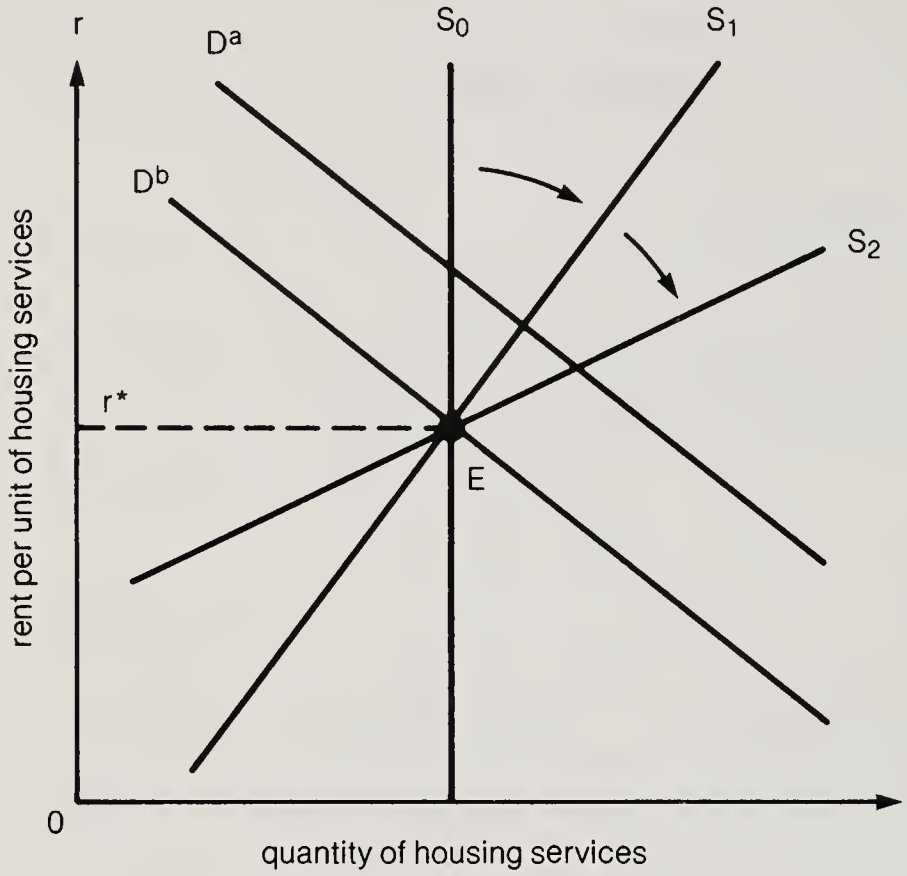
A standard model of the housing market is employed, implicitly or explicitly, in almost all policy analysis related to housing.[12] Its basic feature is the treatment of housing as having only one attribute - the quantity of housing services provided. This quantity is measured by the rent it would have commanded at some specific point in time.[13]

To explain the operation of this model, we shall now use it to analyse the effects on the housing market of a housing subsidy paid to the renter. Figure 1 describes the market graphically. The vertical axis measures the rent received by the landlord per unit, and the horizontal axis measures the quantity of housing services provided in the market. The market demand curve prior to the subsidy, D^b, relates the total quantity of housing services demanded by residents to the rent per unit of housing service. Supply curves relate the quantity of housing services supplied to the market as a function of rent per unit of housing service. The very short-run supply curve, S_0, is almost vertical because during this period (say three months) there is very little housing producers can do to expand or contract the quantity of housing services provided as rent changes. As time passes, the supply curve flattens, since the quantity of housing services becomes more and more responsive to subsidy-induced changes in rent. The long-run supply curve is horizontal at r*. If rents fall below r*, the housing stock will deteriorate and housing starts will decline. The result will be a smaller and smaller quantity of housing services provided in the market.

12 See for example Muth (1968, 1969, 1971) and Olsen (1972).

13 Thus if a housing unit remains unchanged but the rental revenue from it increases due to a rise in the rent per unit of housing service, it is measured as providing the same number of units of housing service as before the rise in rent.

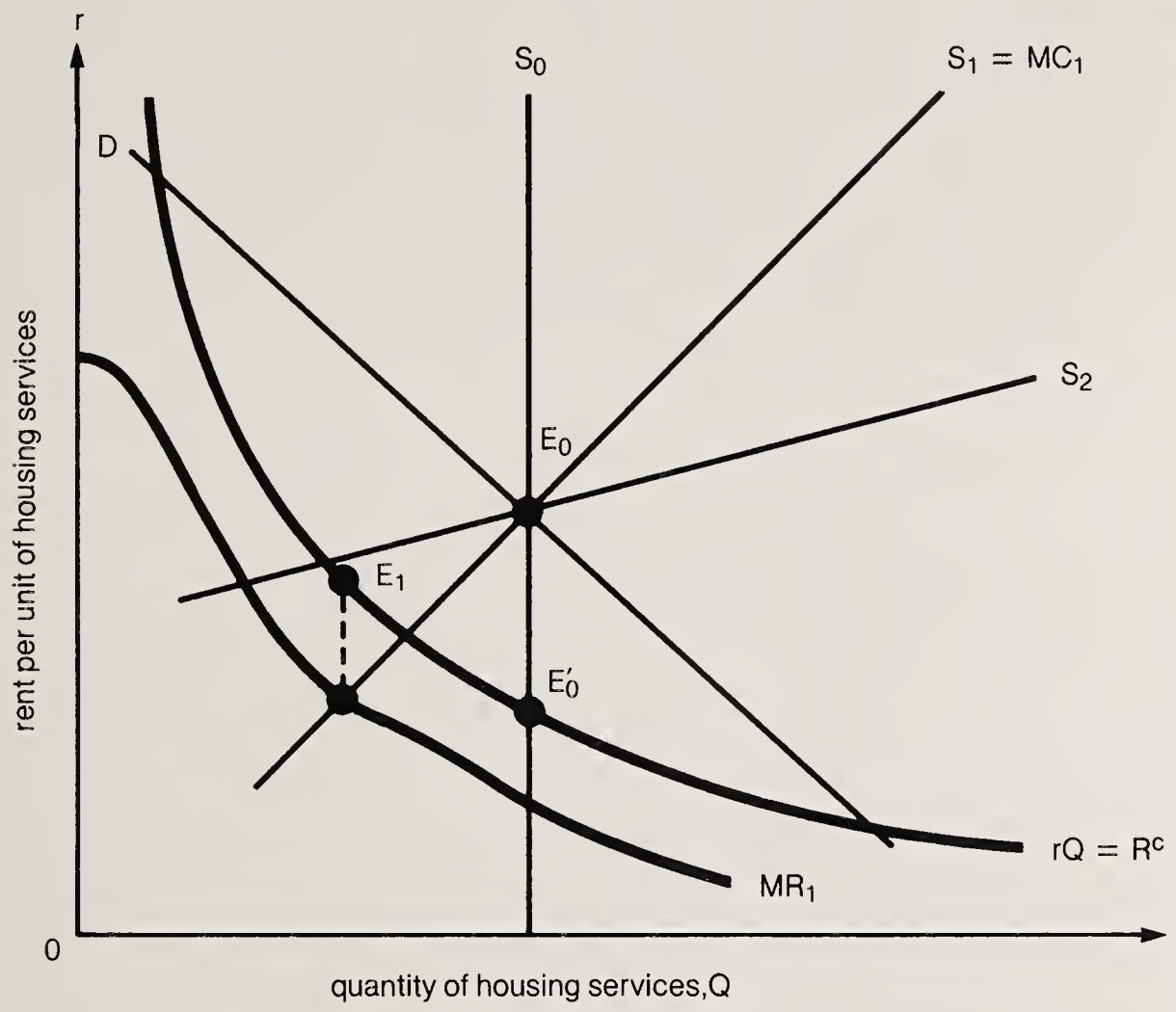
Figure 1
Supply-demand analysis of the housing market



The subsidy drives a wedge between the rent paid to the landlord and the rent net of subsidy paid by the tenant. As a result of the subsidy, therefore, for a given rent paid to the landlord, the quantity of housing services demanded increases. Thus the subsidy causes the demand curve in Figure 1 to shift up from D^b to D^a. The immediate effect of the subsidy is to cause rents to rise. In response to this, landlords spend more on maintenance and the rate of housing construction increases, both of which cause a gradual rise in the quantity of housing services and a gradual fall in rent per unit of housing service back to r*.

Employing empirical estimates of the supply and demand curves, one can use this analysis to predict how the housing subsidy will cause rents and the quantity of housing services in the market to change over time. The analysis can be made more realistic by treating the housing market as a set of submarkets, each of which responds differently to the subsidy. Moreover, if one assumes that the distribution of households by income, demographic group, and so on across the submarkets is unaffected by the subsidy, one can estimate its distributional impact.

Figure 2
Supply-demand analysis of rent control



Unfortunately, this standard method of housing market analysis is ill-suited to the examination of rent control. The conventional textbook discussion of controls treats them as placing a ceiling on rent per unit of housing service. If this were indeed their effect, controls would always cause excess demand and would clearly help tenants. In fact, controls constrain the rent on a physical unit of housing, not on an abstract unit of housing service. In response to rent control, landlords may cut back on maintenance so much that there is no excess demand for rent-controlled housing, and the quality of housing may fall so rapidly that the rent per unit of housing service actually rises.

Frankena (1975) recognizes this deficiency in the textbook analysis and treats rents control as imposing a revenue constraint on a physical housing unit. However, his analysis, while sound, is not sufficiently detailed to distinguish between different rent control programs. A modified version of his analysis is illustrated by Figure 2. Let Q(t) be

the quantity of housing services provided by a particular housing unit at time t (not to be confused with q(t), which will be used later to denote housing quality), r(t) be rent per unit of housing service, and $R^c(t)$ be the rent-controlled revenue for the housing unit. Then rent control imposes the requirement that $r(t)Q(t) \leq R^c(t)$.

Prior to the imposition of controls, equilibrium for a particular housing unit is at E_0. Controls are imposed, requiring that revenue from the housing unit, R^c, be less than at E_0. In the very short run, the landlord cannot adjust the housing services provided by his housing unit and has no alternative but to accept the loss in revenue. Thus the equilibrium immediately after the imposition of controls is E_0'. As time goes on, however, he can lower quality by cutting back on maintenance.

S_1 indicates the marginal cost of increasing housing services via maintenance (or, more generally, expenditure on the housing unit) over a period of, say, one year after controls have been imposed. The faster the landlord runs down his building, the lower the discounted present value of his revenue from it. One may therefore draw in a marginal revenue curve, which relates the increase in the discounted present value of revenues as a result of the building providing one more unit of housing service at the end of one year. The profit-maximizing landlord will choose that level of housing services at which his marginal revenue equals his marginal cost. If he can lease his apartments for the controlled rent at this level of housing services, as he can in Figure 2, the equilibrium one year after controls have been applied will be at E_1. Note that there is excess demand at E_1.

S_t gives the average annual marginal cost[14] of increasing housing services via maintenance; t is the time in years after the application of controls. MR_t gives the average annual increase in the discounted present value of revenues from a unit increase in housing services at the end of year t. The intersection of S_t and MR_t gives the equilibrium at time t. It is possible that eventually the rent per unit of housing service will rise above its precontrol equilibrium level. It may even rise enough to eliminate excess demand.

This analysis is useful in indicating possibilities, but it is not really predictive. It fails to explain how one determines the positions of S_t and

14 By 'average annual' is meant the discounted sum divided by the time period.

MR_t, and it treats the durability of housing and the relationship between stocks and flows in an awkward fashion. The traditional supply-demand model of the housing market is too blunt a tool to provide a really satisfactory analysis of even the simplest rent control program, and it is quite inadequate for any analysis that seeks to distinguish among forms of programs.

4
The effects of rent control: a new model of the housing market

This chapter develops a new conceptual framework for analysing rent control. It then uses this framework to investigate the effects of three illustrative rent control programs, all of which resemble Ontario's program in certain respects.

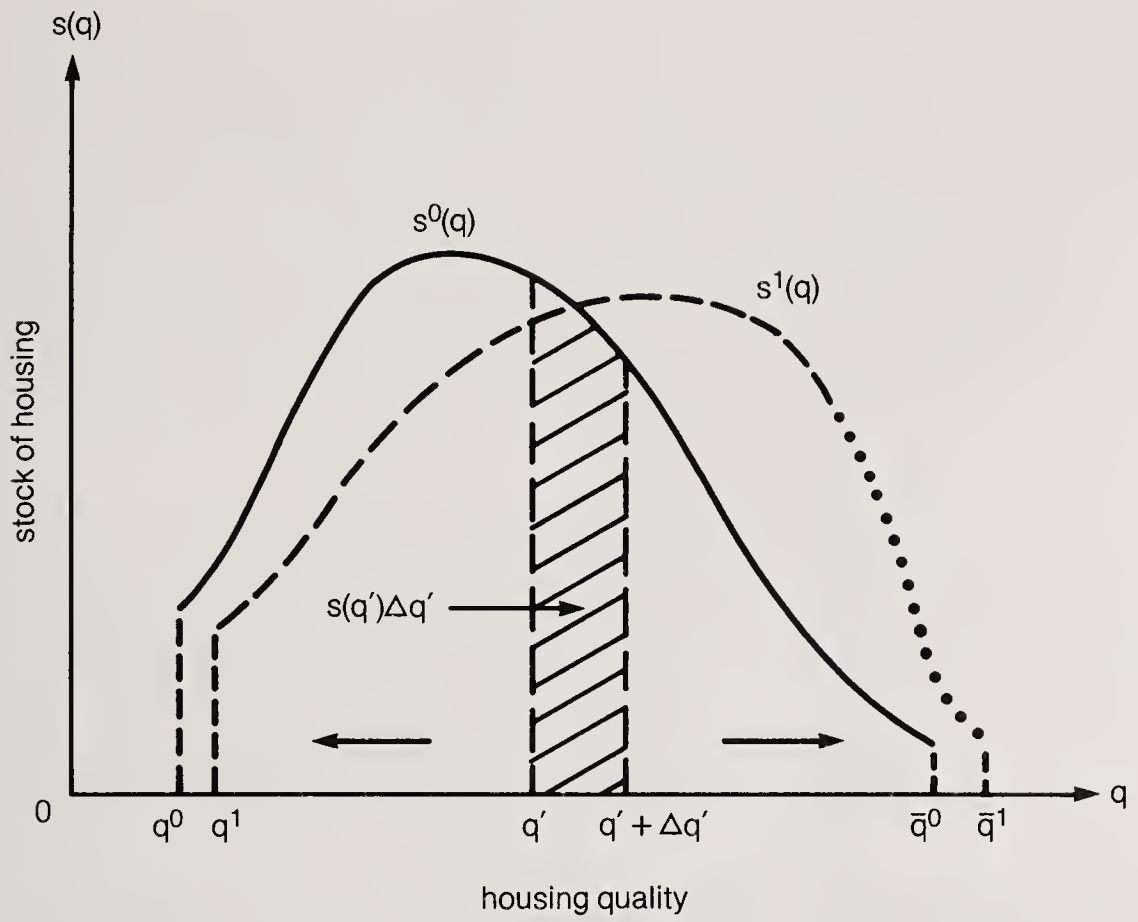
This alternative model of the housing market differs from the supply-demand model described in the last chapter in two important ways. First, it treats a housing unit as having not one attribute, the quantity of housing services, but two - quality and size. Size is measured as the floor area of the physical housing unit and quality by an index of other housing attributes. Second, it deals explicitly with stock-flow relationships, which is necessary for a proper treatment of housing durability.[1]

AN OVERVIEW OF THE MODEL

At any point in time, the stock of housing in the housing market is described by the function $s(q)$, where $s(q')\Delta q'$ denotes the quantity of housing (in terms of square feet of floor space) between quality levels q' and $q' + \Delta q'$. The maximum quality of housing in the market is $\bar{q}$ and the minimum $\underline{q}$. All this is shown in Figure 3 for two points in time, 0 and 1. Changes in the stock variable, $s(q)$, follow mechanically from changes in the flow variables: new housing is constructed, most of it at the higher quality levels, while existing housing changes in quality - most of it down the quality scale. Imagine q to be the distance from the downtown core on

1 This way of modelling the housing market draws heavily on the work of Sweeney (1975a, 1975b). Antecedents of the model are the models of Moorhouse (1972) and Rothenberg (1975).

Figure 3
The housing stock over time



an urban expressway and s(q) to be the density of traffic at location q going downtown during the morning rush hour. The speed of the traffic stream at location q is analogous to the speed at which housing of quality q declines in quality; the entry flow onto the road at q is analogous to the flow of housing constructed at q; the exit flow off the road at q is analogous to the flow of housing demolished at q. The volume and quality composition of housing depend on the profitability of new construction at the various quality levels. The speed at which housing declines in quality depends on the level of profit-maximizing maintenance. Housing is demolished at that quality level at which it becomes profitable to tear down an existing building and construct a new, usually higher-density one in its place.

In Figure 3, $s^0(q)$ indicates the initial stock of housing as a function of quality; $s^1(q)$ is the corresponding function a period later. The dotted part of $s^1(q)$ corresponds to housing constructed during the period, while the dashed part corresponds to previously existing housing that has de-

clined in quality over the period but has not been demolished. In this example, the stock of high-quality housing has risen over the period and that of low-quality housing has fallen, while both the highest and lowest qualities of housing in the market have increased.

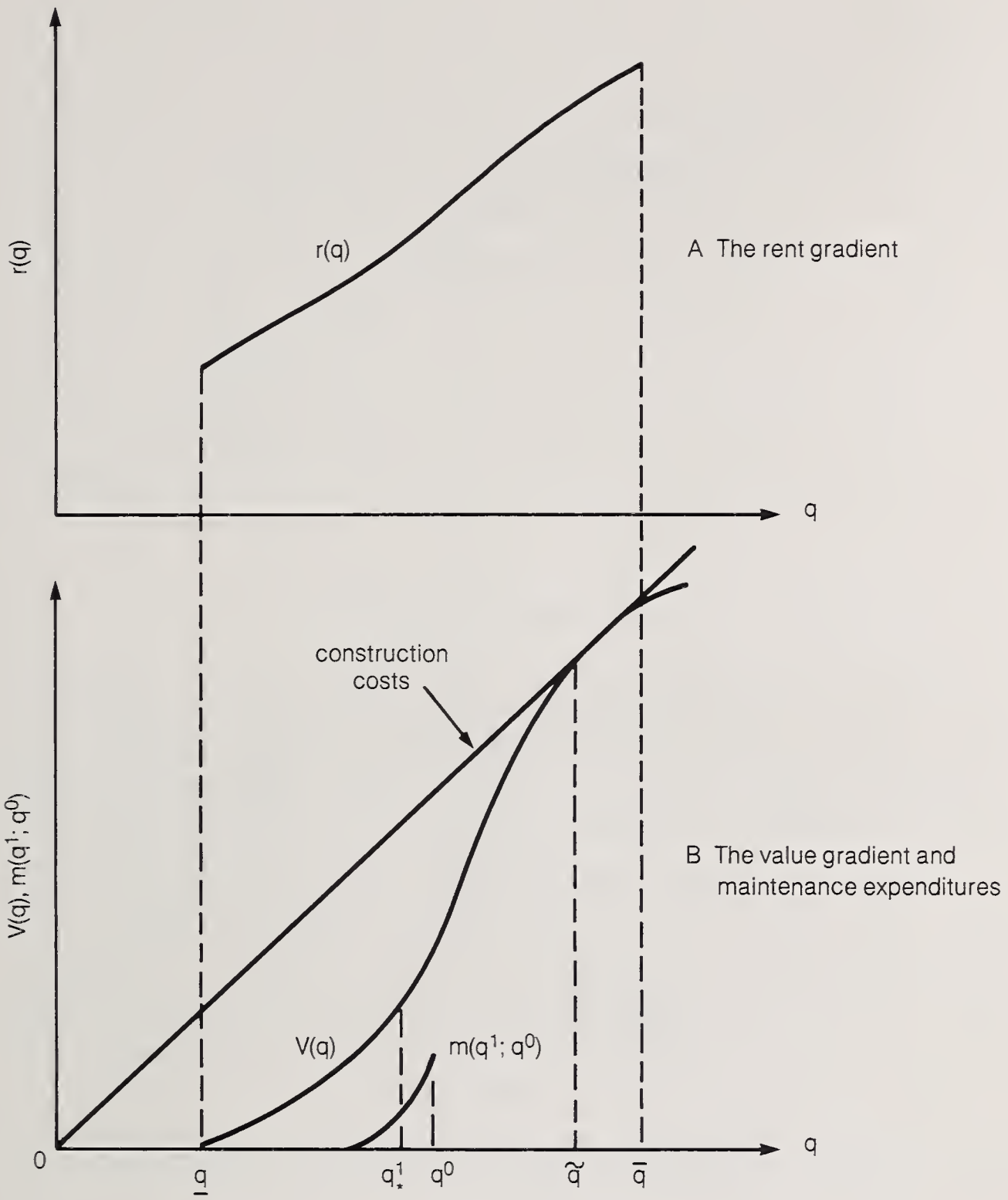
At any point in time, there is a fixed population in the housing market. Households may differ in terms of income, demographic group, etc. Associated with the fixed population and fixed housing stock is a market-clearing rent gradient, r(q), which gives rent per square foot of floor space of a housing unit of quality q. With this rent gradient, which is shown in part A of Figure 4, the quantity of housing supplied in each quality interval equals the quantity demanded. How the rent gradient is determined is described later in this section.

On the basis of anticipated changes in such things as the city's population, landlords can estimate the discounted present value of rents net of maintenance and other costs associated with buildings of different current qualities. On the basis of these expectations, a housing market value gradient, V(q), is established, which gives the market value per square foot of floor space for a housing unit of quality q. This is shown in part B of Figure 4.

The above characterization of the housing market is a natural and useful one. It is important, however, to recognize that the model omits a number of housing markets' actual features. First, it assumes that the rate at which a housing unit declines in quality depends directly only on its initial quality and subsequent level of maintenance, not on its age. Thus two units of the same size and quality on which the same amounts are spent on maintenance are assumed to decline in quality at the same rate, even if they are of different ages.[2] Second, since the model treats units of the same size and quality as commanding the same rent, it implicitly ignores many market imperfections. Third, it assumes that two units of the same quality at one point in time will continue to command the same rent, even though they might change in quality at different rates.

2 Whether or not this is a bad assumption is moot. Wood-frame housing develops wood rot; this is an age-dependent form of deterioration. However, for housing built of other materials, notably brick, granite, steel, and concrete (which actually hardens with age), there is no obvious age-dependent form of deterioration.

Figure 4
The rent and the value gradients



THE ECONOMIC OPERATION OF THE HOUSING MARKET IN THE MODEL

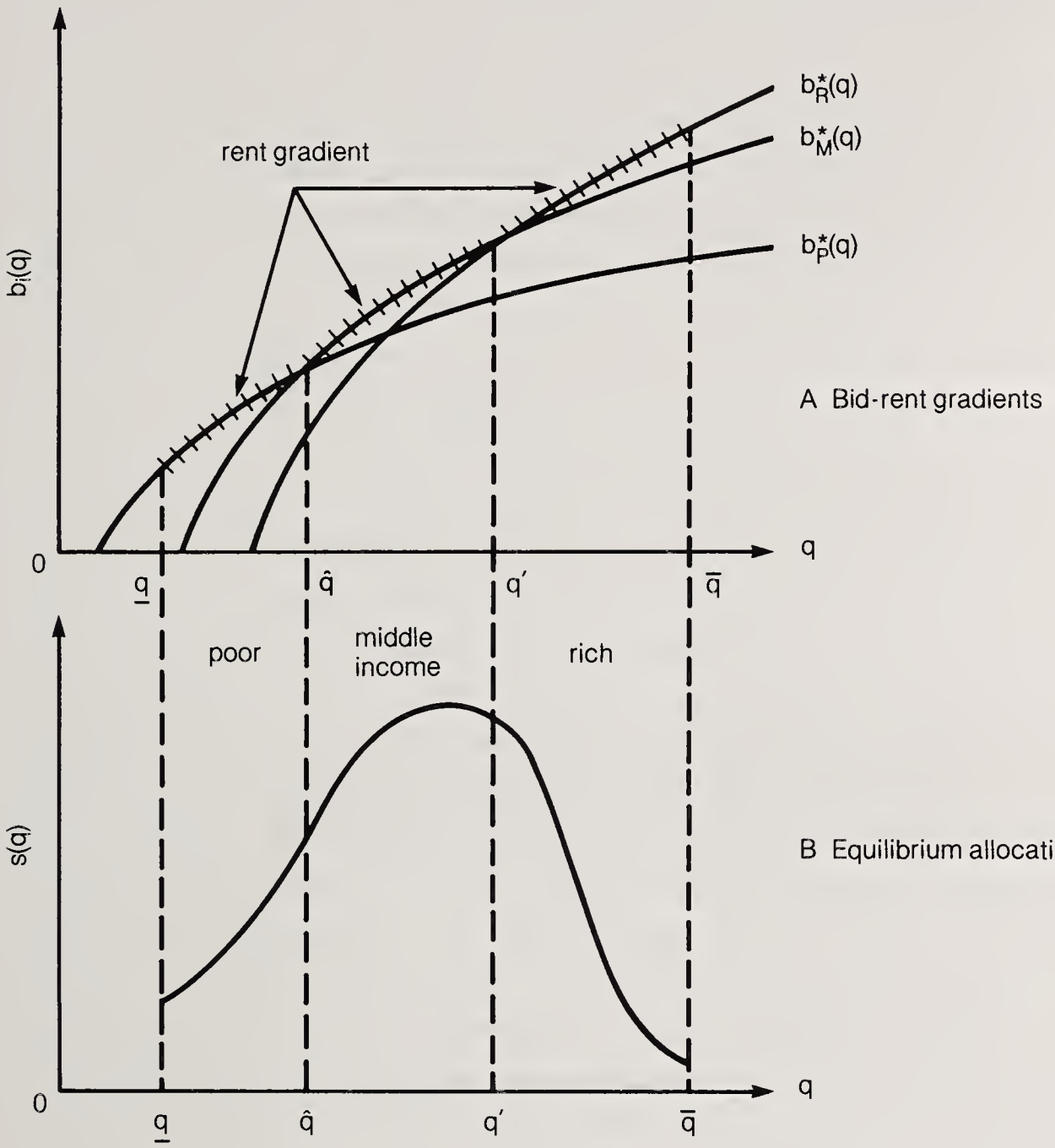
This section explores the economics of the evolution of the market, an evolution determined by builders' decisions as to how much housing to construct at various quality levels, and by landlords' decisions concerning

how much to spend on maintenance at every quality level and at what quality level to demolish an existing building and have a new one constructed on the site. The sequence of the discussion follows the systematic application of the model. First, given an initial (at time 0) stock of housing as a function of quality, $s^0(q)$, one determines the initial rent and value gradients, $r^0(q)$ and $V^0(q)$ respectively. Second, given $V^0(q)$, it is possible to establish the profit-maximizing level of maintenance expenditures during the subsequent period (between times 0 and 1) for every quality level. With this known, one can ascertain by how much each housing unit in existence at the beginning of the period changes in quality; this in turn determines $\tilde{s}^1(q)$, the stock of that housing by quality at the end of the period. Third, one obtains the stock of housing demolished during the period, $\bar{s}^1$, and the stock of newly constructed housing by quality, $\hat{s}^1(q)$. With results for all three categories of stock, one can now determine $s^1(q)$, the total stock of housing as a function of quality at the end of the period.

The determination of the rent and value gradients

A simple example will demonstrate the way in which the rent gradient is determined. Suppose that there are three groups in the population - the poor, the middle income, and the rich - and that the households within each group are identical. A bid-rent curve for the poor is defined as the locus of rent/housing quality pairs between which poor households are indifferent. Such a bid-rent curve is indicated by $b_p^*(q)$ in Figure 5. As a poor household moves up this bid-rent curve, its gain in satisfaction from higher quality is just offset by the higher rent it must pay. There is a family of bid-rent curves for the poor, each corresponding to a different level of satisfaction; at a given quality level, a household is better off the less it has to pay per unit of housing. Thus the bid-rent curves for the poor cannot intersect, and higher bid-rent curves are associated with lower levels of satisfaction. As shown in Figure 5, the rich and middle-income groups have corresponding families of bid-rent curves. Since a rich household will typically pay a larger premium per unit of quality to live in a higher-quality housing unit than will a middle-income or poor household, the bid-rent curves of the rich are usually the steepest and those of the poor the flattest.

Figure 5
Equilibrium rent gradients and the allocation of housing



Equilibrium in the housing market requires the following conditions:

- All households in a particular group must receive the same level of satisfaction (otherwise all households in the group would want to move to those housing units offering the highest level of satisfaction, which is inconsistent with equilibrium).
- Housing goes to the group that bids the most for it. (The rich will

not outbid poor and middle-income households for all housing units; if they did, they would receive all the housing.)

- The quantity of housing occupied by each group must equal the quantity of housing demanded by that group.

These conditions together imply a unique equilibrium rent gradient and a unique equilibrium allocation of households among housing units. The assumed equilibrium is shown in Figure 5. From the first condition, equilibrium is characterized by one level of satisfaction for the poor, which corresponds to the unique (equilibrium) bid-rent curve $b_P^*(q)$ in part A; another level of satisfaction for middle-income households, which correspond to the unique bid-rent curve $b_M^*(q)$; and a third level of satisfaction for the rich, which corresponds to the unique bid-rent curve $b_R^*(q)$. Given the three equilibrium bid-rent curves, one can determine the equilibrium rent gradient and allocation. At quality $\bar{q}$, for example, the rich bid more per unit of housing than middle-income or poor households. In consequence, the housing at this quality level goes to the rich, and the market rent equals the amount the rich bid for it. Employing this argument at every quality level, one finds that the equilibrium rent gradient is the 'upper envelope' of the equilibrium bid-rent curves of the three groups (shown as the crosshatched line in the figure). In Figure 5, the poor occupy housing between quality levels $\bar{q}$ and $\hat{q}$, since they bid the most for housing in this quality interval. Similarly, middle-income households occupy the housing between qualities $\hat{q}$ and q', and rich households occupy housing between qualities q' and $\bar{q}$. For $b_P^*(q)$, $b_M^*(q)$, and $b_R^*(q)$ to be the equilibrium bid-rent curves, the quantity of housing going to each group must equal the corresponding quantity demanded, given the associated rent gradient.

The market value of a housing unit equals the discounted present value of anticipated rents less anticipated maintenance and other expenditures, appropriately adjusted for risk.[3] Market value therefore depends on landlords' expectations about the future.

3 This statement is strictly correct only when landlord-builders have identical expectations. How a market price is determined when agents differ in their expectations is a topic that is being extensively researched.

Profit-maximizing maintenance expenditures

During each period, a landlord's expenditure on maintenance will be such that the last dollar spent increases his building's value by one dollar. Consider a landlord who has a housing unit of quality q^0 at the beginning of a given period. The curve $m(q^1;q^0)$ in Figure 4 indicates the quality of the housing unit at the end of the period, q^1, as a function of maintenance expenditures during the period. This function characterizes the existing maintenance technology. In Figure 4, the optimal level of maintenance for a building of quality q^0 occurs at q^1_*, where V(q) is parallel to $m(q^1; q^0)$. Thus optimal maintenance expenditures for this housing unit are $m(q^1_*;q^0)$. Notice that, with this level of maintenance expenditures, the unit's quality falls over the period.

By performing this exercise at every quality level, one can calculate the speed at which housing of every quality filters downwards. That is, given $V^0(q)$, $s^0(q)$, and $m(q^1;q^0)$, one can solve for $\tilde{s}^1(q)$.

The construction and demolition decisions

We must now determine the amount of housing constructed and demolished at the various quality levels. Housing will be constructed at every quality level at which the market value of a housing unit is greater than or equal to construction cost. With the V(q) shown in part B of Figure 4, housing would be constructed only at the upper end of the quality spectrum, between $\tilde{q}$ and $\bar{q}$. The cost of constructing a unit of housing of a particular quality depends on both the total quantity of housing constructed and the quantity of housing constructed of that particular quality. The quantity of housing constructed at each quality level is determined by the profits made from construction. Thus, given $V^0(q)$ and the construction technology, it is possible to ascertain the volume of housing constructed at different quality levels between time 0 and time 1, $\hat{s}^1(q)$.

This valuation formula ignores the fact that housing uses up land. One can treat this without difficulty. The value of a housing unit plus the land associated with it equals the discounted present value of profits associated with the land in perpetuity, taking into account that once a building is demolished a new structure can be erected on the site.

A housing unit will be demolished when the costs of postponing demolition for one period equal the benefits. The costs are the gains in net revenues (rent minus maintenance expenditures) that would have been obtained over the period from a new and probably larger and higher-quality building. The benefits equal the interest on the capital needed to construct a new building. Given these costs and benefits, one can determine the critical quality level in each time period at which housing is demolished. This level is shown as q^1 in Figure 4.

On the basis of the above analysis, $s^1(q)$ is easily determined. And given $s^1(q)$ and the composition of the population at time 1, one can solve for $r^1(q)$ in the same way as $r^0(q)$ was solved for previously. The determination of $V^1(q)$ is rather more difficult, since this depends on how unanticipated demographic changes and the like affect expectations over the period. If there were no uncertainty, $V^1(q)$ could be solved for, given $V^0(q)$ and optimal maintenance expenditures at each quality level, by the condition that landlords must earn a rate of return from housing equal to that they would obtain holding any other asset.

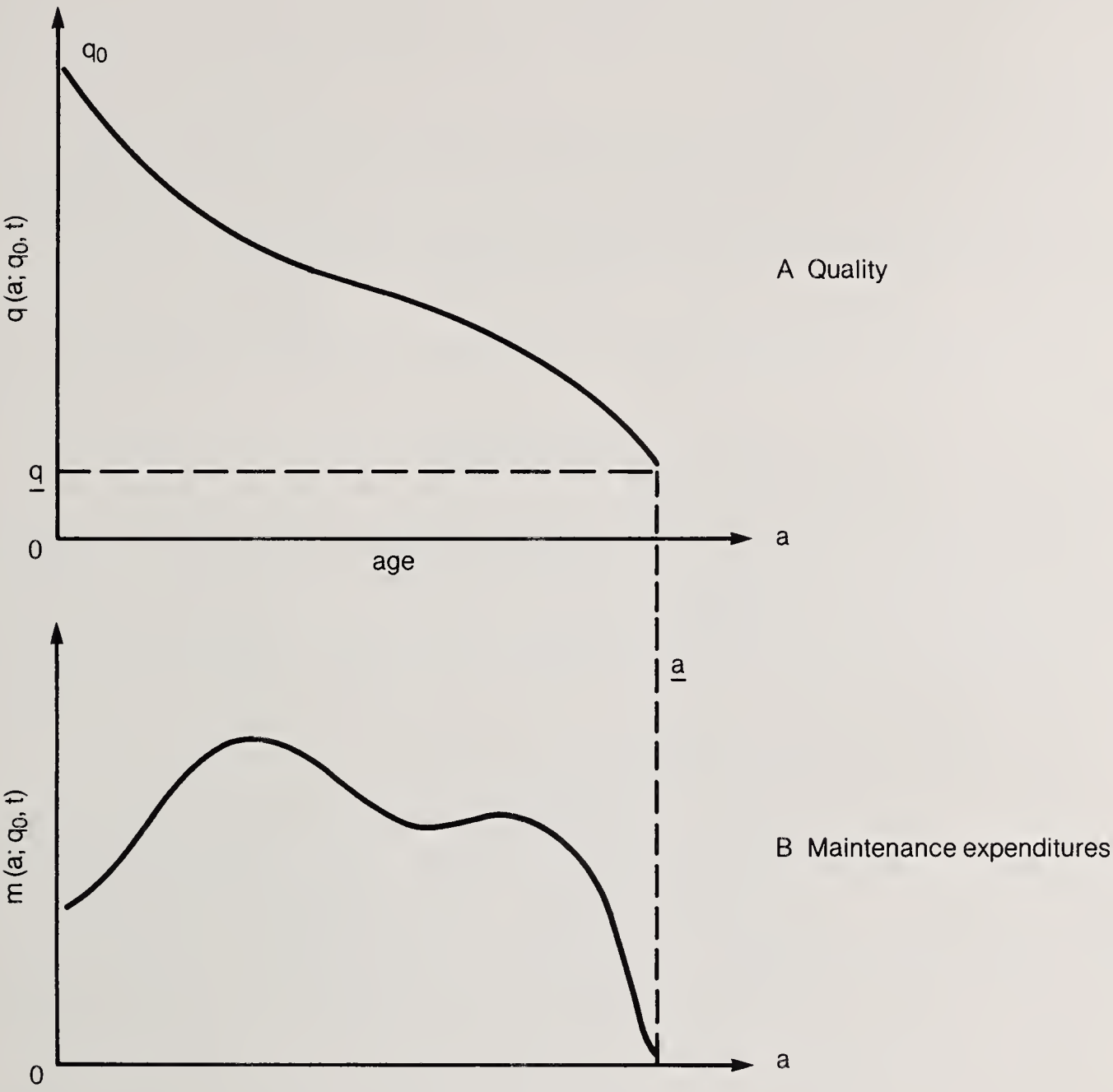
The dynamics of the housing market have now been traced over one period. One can use the same analysis to trace the evolution of that market as far into the future as one desires. The qualitative characteristics of the process are readily summarized: housing is usually constructed at the higher quality levels and gradually declines in quality until eventual demolition. The speed of this decline depends on maintenance and the steepness of the value gradient. In each period, rents adjust to clear the market.

So far, this discussion has focused on the operation of the housing market as a whole, but the model also allows one to trace the history of each housing unit. This can be characterized by two functions, $q(a;q^0,t)$ and $m(a;q^0,t)$, which relate the quality of and maintenance expenditures for a particular housing unit to its age, a, given its initial quality, q^0, and time of construction, t. These are shown in Figure 6. If one knows these functions for each housing unit in the market, it is only a matter of addition to obtain the behaviour of the market as a whole.

RENT CONTROL

It should now be apparent how one uses this model of the housing market to assess the effect of a rent control program: one solves for the

Figure 6
Quality and maintenance expenditures as functions of age



future of the market without controls, then repeats the process taking the program into account. The difference between the two futures is ascribable to rent control.

In this section, the model is employed in such a manner to analyse the effects of three stylized rent control programs, all of which bear some resemblance to Ontario's current program. The first is a pure guideline increase program, which specifies a maximum allowable percentage increase in rents per year; the second is a pure cost pass-through program, which allows landlords to raise rents by no more than their increase in costs; the third is a mixed guideline increase/cost pass-through (GI/CPT) program,

which permits rents to be raised by the maximum of the increase in costs and the guideline increase. It was explained earlier that Ontario's program is essentially of the GI/CPT type, though it contains complicating features such as the hardship provision.

Introduction to the analyses

A cataloguing of the qualitative effects of a given rent control program for a range of different circumstances would be a tremendous task. To keep the analysis manageable, several assumptions must be made.

1. The equilibrium rent gradient, measured in real or constant dollars, is fixed over time.
2. The rent control program is unanticipated, there is no uncertainty, and landlords have perfect foresight.
3. Each program is without a time limit and exempts housing constructed after the imposition of controls.[4]
4. The quality level at which housing is demolished is unaffected by the rent control program.
5. The housing market is competitive.

Assumption 1 holds if the whole economy of which the rent-controlled jurisdiction is a part is stationary, and if the rent-controlled jurisdiction is small relative to the whole economy. The assumption is relaxed at several points in the subsequent discussion. How the results change when assumptions 2 and 3 are relaxed will be touched on later. Assumption 4 is true when controls are not binding at the low end of the quality spectrum, which, it will be argued, is the case when controls contain a cost pass-through provision. In most other circumstances, however, controls cause housing to be demolished at a higher quality level than it would be without controls, since they reduce the benefits of postponing demolition.

These assumptions are obviously not completely realistic. At the very least, however, the subsequent analysis based on them:

4 Since new housing is exempt, rent control will affect the market only until all the housing that existed when controls were imposed is demolished.

- illustrates the method of analysis that one would want to apply in a full study of a rent control program;

- demonstrates that the qualitative effects of a given rent control program can vary widely as a function of the specific maintenance technology, market conditions, and other characteristics of the situations to which it is applied;

- shows that the effects of a rent control program reflect the details of the program;

- brings to light some general principles concerning rent control. (It is shown, for example, that there is no simple relationship between the excess demand caused by controls and the efficiency loss ascribable to them.)

We hope that the analyses will do more than this. Indeed, the qualitative results of the GI/CPT controls case accord so well with the observed qualitative behaviour of landlords in today's Ontario housing market that it would seem analysis does shed light on the actual behaviour of that market under the current form of controls. So the above assumptions are probably not unduly restrictive.

The analyses are conducted in terms of real or constant dollars. Thus a rent control program that specifies a guideline rent increase of x per cent in nominal terms when the inflation rate is i per cent is treated as a program that specifies a guideline increase of $(x - i)/(1 + i)$ per cent in real terms. The costs passed through under a cost pass-through provision are also measured in real terms.[5]

PURE GUIDELINE INCREASE CONTROLS

This analysis will examine how a guideline increase program affects the housing decisions of one landlord-builder. From these decisions, con-

5 Ontario's rent control program has a number of provisions that cause its effects to depend on the rate of inflation. Notably, the way in which costs are measured for the purposes of cost pass-through makes the real costs that may be passed through depend on the inflation rate. For analysis, this complication may be circumvented by assuming that the inflation rate remains constant.

clusions can be drawn about the effect of such controls on the market as a whole. It should be noted that while the following discussion of maintenance expenditures is applicable only to guideline increase controls, much of the subsequent discussion in this section applies to any form of controls.

Maintenance expenditures

A representative landlord-builder's profit-maximization program can be characterized by a diagram that plots real profit-maximizing maintenance expenditures against housing quality.[6] In Figure 7, ABC plots the assumed profit-maximizing maintenance path in the absence of controls. In this case, the landlord constructs his building at quality $\bar{q}$ and spends $\bar{m}$ on maintenance during the first year of operation. This is not enough to keep up the quality of the building, and it deteriorates. Real maintenance expenditures rise during the first years of the building's operation and fall thereafter[7] until, just prior to demolition, the landlord spends nothing on maintenance. The quality of the building falls throughout its life.

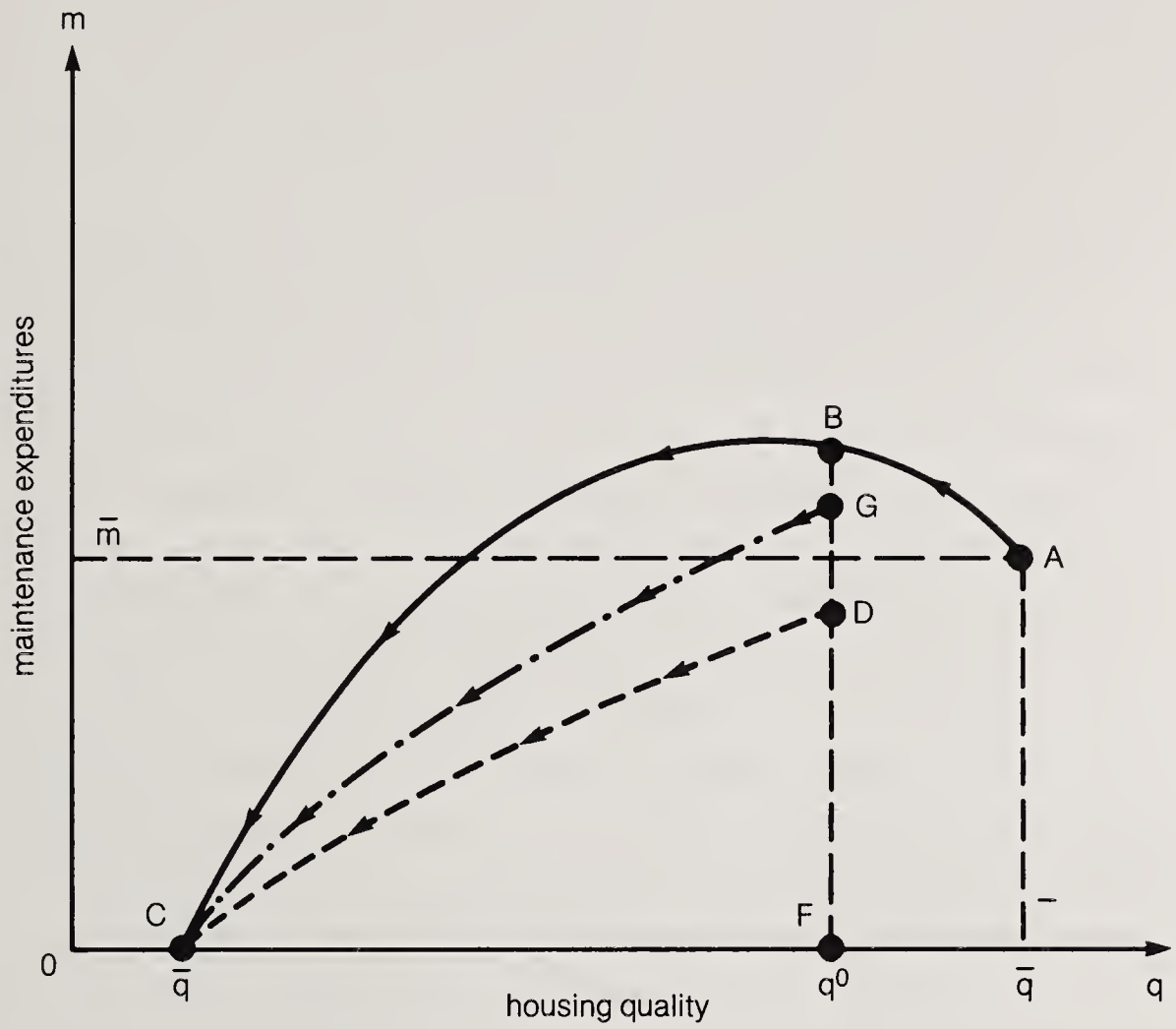
Now suppose that guideline increase controls are imposed on the market. Such controls may be ineffective at all quality levels (for example, they may specify that a landlord cannot raise rents by more than 20 per cent per year, when given his profit-maximizing maintenance path, he would only want to raise them by 10 per cent per year), effective at all quality levels, or effective at some and ineffective at others. For simplicity's sake, this analysis assumes that the controls are effective at all quality levels except perhaps the lowest, but it should be kept in mind that this need not be the case.

Consider a building that is of quality q^0 at the time guideline increase controls are imposed. The landlord can follow one of two qualitatively different maintenance paths. Along the first, he cuts back on maintenance by just enough to ensure that he can rent his housing but has no excess demand; that is, he allows quality to fall at such a speed that the controlled rent equals the market-clearing rent. This is path DC

6 The discussion in this section is based on formal analyses presented in Arnott (1979) and Arnott, Davidson, and Pines (1980).

7 A sufficient condition for the maintenance path to have this shape is that the depreciation function $\dot{q} = g(q,m)$ be separable in q and m.

Figure 7
Pure guideline increase controls



in Figure 7. When rent control is imposed, the landlord cuts maintenance expenditures from FB to FD and continues to spend less at every level of housing quality on maintenance than he would have spent in the absence of controls. The second path also involves his cutting back on maintenance expenditures, but not by so much. Housing quality falls less rapidly than is necessary for the controlled rent to equal the market-clearing rent; the housing is therefore in excess demand.[8] In Figure 7, GC is such a path. Intermediate situations are also possible in which a housing unit is in excess demand along some segments of the profit-maximizing path but not

8 This is inconsistent with assumption 4. To eliminate the inconsistency would greatly complicate the discussion while adding little.

along others; to simplify the analysis, such situations are ignored in the subsequent discussion.

Which maintenance path will the landlord actually follow under this form of rent control? Assume that the landlord has decided to follow an excess demand path and to demolish his building at $\underline{q}$, the assumed demolition quality, T years after the imposition of controls. Since he will always charge the controlled rent and has chosen T, he knows the present value of rents associated with the building; and since the economy is stationary and new buildings are exempt from controls, he knows the present value of profits associated with subsequent buildings. His problem, therefore, is to minimize the present value of maintenance expenditures, subject to running down the quality of his building to $\underline{q}$ in T years. He computes the discounted profits associated with each T and chooses the profit-maximizing T. The larger is T, the higher are both discounted maintenance expenditures and discounted rents associated with the building, and the lower are discounted profits associated with subsequent buildings on the site. The profit-maximizing T that falls out of this calculation may be so short (that is, he would like to run down the building's quality so quickly) that along this path the controlled rent would exceed the market-clearing rent. But in a competitive market with a price ceiling, rent cannot exceed the market-clearing rent. In this case, then, the landlord will choose to run down the building at such a speed that the controlled rent will just equal the market-clearing rent.

The above discussion has two important implications. First, if guideline increase controls - or indeed controls of any kind - cause little or no excess demand in a housing market, they do not necssarily have only a small effect on that market. Rather, the structure of market-clearing rents and the maintenance technology may be such that landlords choose, as a result of rent control, to run their buildings down quickly. Since an absence of excess demand is associated with rapid downgrading, it may be a bad sign if a rent-controlled housing market has no excess demand. Moreover, the amount of excess demand in a rent-controlled housing market does not necessarily measure how 'binding' controls are; instead, it may reflect the structure of rents and the maintenance technology.

Second, in the years immediately following the imposition of rent control, book profits may be higher than they would have been without

controls. In the example, at the moment controls are imposed, maintenance expenditures fall while rents remain the same; as a result, book profits rise. This does not mean that landlords profit from controls, since the larger book profits immediately after the imposition of controls are more than offset by smaller book profits in subsequent years.

Distributional effects with no excess demand

When there is no excess demand, rent equals the market-clearing rent. When assumption 1 holds - that is, when the equilibrium rent gradient is fixed over time - controls of any kind have no effect on the market-clearing or equilibrium rent gradient. Thus, when controls cause no excess demand and when assumption 1 holds, tenants are made neither better off nor worse off by controls. Landlords are the losers and suffer capital losses equal to the discounted present value of the efficiency loss associated with controls being applied to their buildings.

When assumption 1 does not hold, the analysis of the distributional effects associated with controls becomes considerably more complicated, since it is now necessary to consider the way in which controls alter the market-clearing rent gradient. The following is a likely scenario.

The imposition of controls causes rental housing to decline in quality more rapidly than would otherwise be the case. In the short run, the stock of low-quality housing increases at the expense of medium- and upper-medium-quality housing. Consequently, the market-clearing rents on low-quality housing fall, making the poor better off, and the market-clearing rents on medium- and upper-medium-quality housing rise, making middle-income households worse off. What about the rich? Since the stock of upper-medium-quality housing has fallen, one might expect the market-clearing rents on high-quality housing to rise. But if this does occur, it immediately becomes very profitable to construct high-quality housing. The fact that uncontrolled housing is constructed at the top end of the quality spectrum tends to fix rents on high-quality housing. In the medium run, it is the supply of low-quality housing that shrinks. Most medium- and high-quality housing, constructed after the advent of controls and therefore exempt from them, is likely to rent for about what such housing cost before controls were imposed. Thus, in the medium run, when rent control causes no excess demand and when assumption 1 does

not hold, landlords and poor tenants are the likely losers from controls, while middle-income and rich tenants are likely to be neither much better nor much worse off. In the long run, when all existing housing has been constructed after the imposition of controls and hence is uncontrolled, the precontrol equilibrium is re-established.

The gains and losses to tenants are flows, while the losses to landlords are stocks. The loss to a landlord comes in the form of a sudden reduction in the value of his property upon the imposition of controls. It is the landlords who own property when controls come into effect who lose; subsequent owners are neither hurt nor helped by controls.

Something must be said about the interdependence between the rental and owner-occupied housing markets. For example, if the market-clearing rent on low-quality housing rises, some poor renters who previously preferred to rent will now decide to own. This will increase the demand for substitutable, presumably low-quality, owner-occupied housing, resulting in a windfall gain for the owners of such housing. The implication is that if a group of tenants is hurt by controls, the corresponding group of owner-occupiers is helped, and vice-versa. However, the situation is complicated by the fact that controls also affect the quality composition of the owner-occupied housing stock[9] and by capital market imperfections that make rental and owner-occupied housing imperfect substitutes.

Distributional effects with excess demand

When controls cause excess demand in the housing market, their distributional effects are far more difficult to analyse. The market splits into two submarkets, the uncontrolled submarket and the controlled submarket in which there is excess demand. Families that cannot obtain controlled housing must rent uncontrolled housing constructed after the imposition of controls, most of it of medium and high quality. The distributional effects depend on:

- how controls affect the market-clearing rent gradient (this has already been discussed);

9 Via induced changes in the level of maintenance expenditure on owner-occupied housing and in the quality composition of new owner-occupied housing constructed, and via tenure conversion.

- at what quality levels excess demand is high and at what quality levels it is low;
- how housing in excess demand is rationed.

The extent of excess demand can be measured approximately by the difference between the controlled rent and the market-clearing rent at a particular quality level. As noted earlier, this difference depends on the characteristics of the given maintenance technology. Unfortunately, very little is known about maintenance technologies in general. Thus it is very difficult to predict which housing submarkets will experience considerable excess demand as a result of controls and which will not.

How is the housing in excess demand rationed? The rational, law-abiding landlord will choose easy and inexpensive tenants, those who will stay a long time, look after their apartments well, and not be a nuisance to the neighbours. If he feels that these characteristics are positively correlated with income, he will probably ration on that basis. If, however, he is required by law not to discriminate in this way, his apartments may go to those who have been on his waiting list the longest; these will usually be long-term residents of the community. He also has a strong incentive to ration illegally, by demanding key money.

Given a mix of these three rationing mechanisms, the rich are clearly winners. The quality-adjusted rent on uncontrolled housing constructed after controls are imposed is likely, for reasons given earlier, to be much the same as it would have been in the absence of controls. Thus the rich who live in uncontrolled housing are about as well off as they would have been in the absence of controls, while the rich who live in controlled housing are presumably better off, since they have chosen it over uncontrolled housing. The short-run distributional effects on the middle-income and poor are ambiguous. The scarcity of medium-quality housing may force some middle-income households to settle for low-quality controlled housing or uncontrolled higher-quality housing, while others, because they are good tenants, may obtain controlled higher-quality housing. These offsetting effects tend to operate in the other direction for the poor. The relative abundance of low-quality housing helps them, since they are likely to be able to obtain, at lower rents, more or less the same housing they would have chosen in an uncontrolled market. But because they are likely to be regarded as less desirable tenants than the

middle-income households now competing with them for the same quality housing, the rationing mechanisms work against them.

When excess demand is present, the redistribution within income groups is likely to be at least as pronounced as that between income groups. Long-time residents and good tenants are likely to be winners, new arrivals and poor tenants, losers. Horizontal redistribution of this kind is regarded by many as inequitable.

Even a household that does find housing in the face of controls-induced excess demand is not necessarily better off than it would have been in the absence of controls. The rationing schemes promoted by excess demand produce an inefficient matching of households to housing units. For instance, a middle-income household that would willingly pay the market-clearing rent for a medium-sized, medium-quality apartment may, in a controlled market, have to choose between a large, low-quality controlled unit and a small, high-quality uncontrolled one. In addition, controls are likely to cause a reduction in the quantity of housing services provided by the total stock of housing. This will force up the market-clearing rent for a unit of housing service. As a result, the controlled rent for a unit of housing service may be higher than the uncontrolled rent would have been.

When controls cause excess demand, their effect on owner-occupiers is ambiguous. There are two offsetting effects. The excess demand may spill over into the owner-occupied housing market and drive up prices there, since some renters, not able to find a rent-controlled unit that suits them, may decide to buy. Alternatively, households that would have bought housing in an uncontrolled market may decide to stay in the rental market, either because they have a bargain apartment or because they hope to find one.

Effects on construction

If rent control does not affect the market-clearing rent gradient, then neither does it affect the profitability or the volume of (exempt) rental housing construction at the various quality levels. This statement requires one qualification. If landlord-builders believe that the government may, at some future date, impose controls on rental units constructed after the introduction of controls, the expected profitability of rental

housing construction will fall. This will cause the volume and possibly the average quality level of new rental housing to fall as well.

If rent control does not affect the market-clearing rent gradient or cause excess demand, then it should have no effect on the volume of owner-occupied housing constructed. If it does cause excess demand, the volume of such construction at various quality levels will rise or fall as particular groups of tenants become worse off or better off.

However, it is more likely that controls will affect the market-clearing rent gradient on uncontrolled rental housing and thus the volume of rental housing construction. Tenants living in unsatisfactory controlled housing may hold on to it, hoping to find a controlled unit at a bargain. (This might occur if landlords were to adopt an internal rationing mechanism, alloting newly vacated bargain units to long-term tenants.) Such a practice would cause the demand for uncontrolled housing, and hence the volume of rental housing constructed, to fall. But this is an unlikely outcome of rent control. Controls accelerate the deterioration of rental housing, and this increases its demolition rate. Increased demolition reduces the number of units of housing services provided by controlled housing, causing the market-clearing rent gradient to shift upwards. This in turn should stimulate both rental and owner-occupied housing construction. Indeed, this outcome is what one would logically expect: increased outflow from the housing stock should induce greater inflow.[10]

The above discussion has treated rental housing in the aggregate. When one breaks housing down by quality, the analysis becomes even more complex. Controls may cause the market-clearing rent gradient to shift up at some quality levels and down at others, changing the quality composition of new housing - though in what way is impossible to say a priori.

Tenure conversion

Some of the effects of rent control on the owner-occupied housing market have already been mentioned. Another such effect is its encouragement of

10 Housing construction does have a negative feedback effect on the market-clearing rent gradient. For example, a higher market-clearing rent gradient stimulates new housing construction, which lowers the market-clearing rent gradient. This feedback effect will dampen but not offset the initial effect.

tenure conversion. If there are no regulations restricting conversion, then rental housing will be converted to owner-occupancy status whenever its market value when rented falls below its value when owner-occupied. The forms of conversion include consolidation (reconverting an old house that has been split up into apartments back into a single-family dwelling) and 'condominiumization'. The rapidity and extent of tenure conversion depend on such factors as the cost of conversion, the regulations applying to condominiumization, the nature of capital markets (and thus the number of tenants able to afford owner-occupied housing), the mobility of the population, and the severity of controls. Tenure conversion reduces the efficiency loss associated with controls, but its distributional effects can be undesirable. If extensive tenure conversion is permitted, the obvious losers are the young. Leaving home or marriage may be postponed for want of enough savings to make the down payment on an apartment, and moving to find a better job may be discouraged by the high moving costs associated with owner-occupancy.

Efficiency loss

In principle, the efficiency loss associated with a control program can be measured, but because of inadequate housing-related data this has never been done, not even approximately. It is probable, however, that the annual efficiency loss due to controls increases with the length of time they have been applied. Thus rent control causes the housing pie, which is shared among tenants, landlords, and owner-occupiers, to shrink over time.

The effects of guideline increase controls: a summary

This discussion will have given little satisfaction to those who hoped for a precise documentation of the effects of guideline increase controls. However, it is better to admit ignorance than to pretend knowledge. Theoretical understanding of the operation of the housing market is quite good, but all it leads to is a long cataloguing of possible responses to a given rent control program. Which responses will in fact occur depends on the detailed characteristics of the maintenance technology, housing demand, rationing mechanisms, and expectations formation in the market

under scrutiny. To determine these characteristics requires sophisticated empirical analysis, and this is thwarted by lack of data. Nevertheless, the discussion did generate the following qualitative conclusions.

Guideline increase controls cause landlords to cut back on maintenance expenditures. The result is a more rapid deterioration of the controlled housing than would have occurred in the absence of controls. The distributional effects of any form of controls are complex. Because of efficiency loss, the housing pie shared between landlords and tenants shrinks over time. Thus even though controls make tenants, in the aggregate, relatively better off, compared to landlords, they may in time make tenants absolutely worse off. Guideline increase controls may or may not cause excess demand for controlled rental housing. If the controls cause little or no excess demand, then in the short run poor tenants probably benefit and middle-income tenants suffer, while the rich are not greatly affected. In the middle run, however, middle-income tenants, like the rich, neither gain nor lose significantly from continued controls, while poor tenants suffer. If the controls do cause excess demand, their distributional effects are sensitive to the mechanisms employed to ration controlled housing, and most such mechanisms favour the rich, respectable, and advantaged. The effects of guideline increase controls on the volume of rental housing construction depend to a great extent upon landlords' perceptions. If landlord-builders are confident that rental housing constructed after the introduction of controls will remain exempt, construction normally increases to offset the control-accelerated deterioration and demolition of the pre-control rental housing stock. However, if landlords doubt the permanence of exemptions - as, reasonably or not, they often do - the volume of rental housing construction may fall. Finally, the effects of controls spill over into the owner-occupied housing market by encouraging tenure conversion and substitution, but the extent of these effects is difficult to estimate a priori.

PURE COST PASS-THROUGH CONTROLS

Under this form of controls, landlords may raise rents by no more than the increase in their costs. Since these analyses are being conducted in real terms, our model assumes that if there is a fall in costs, rents must be lowered by at least that amount.

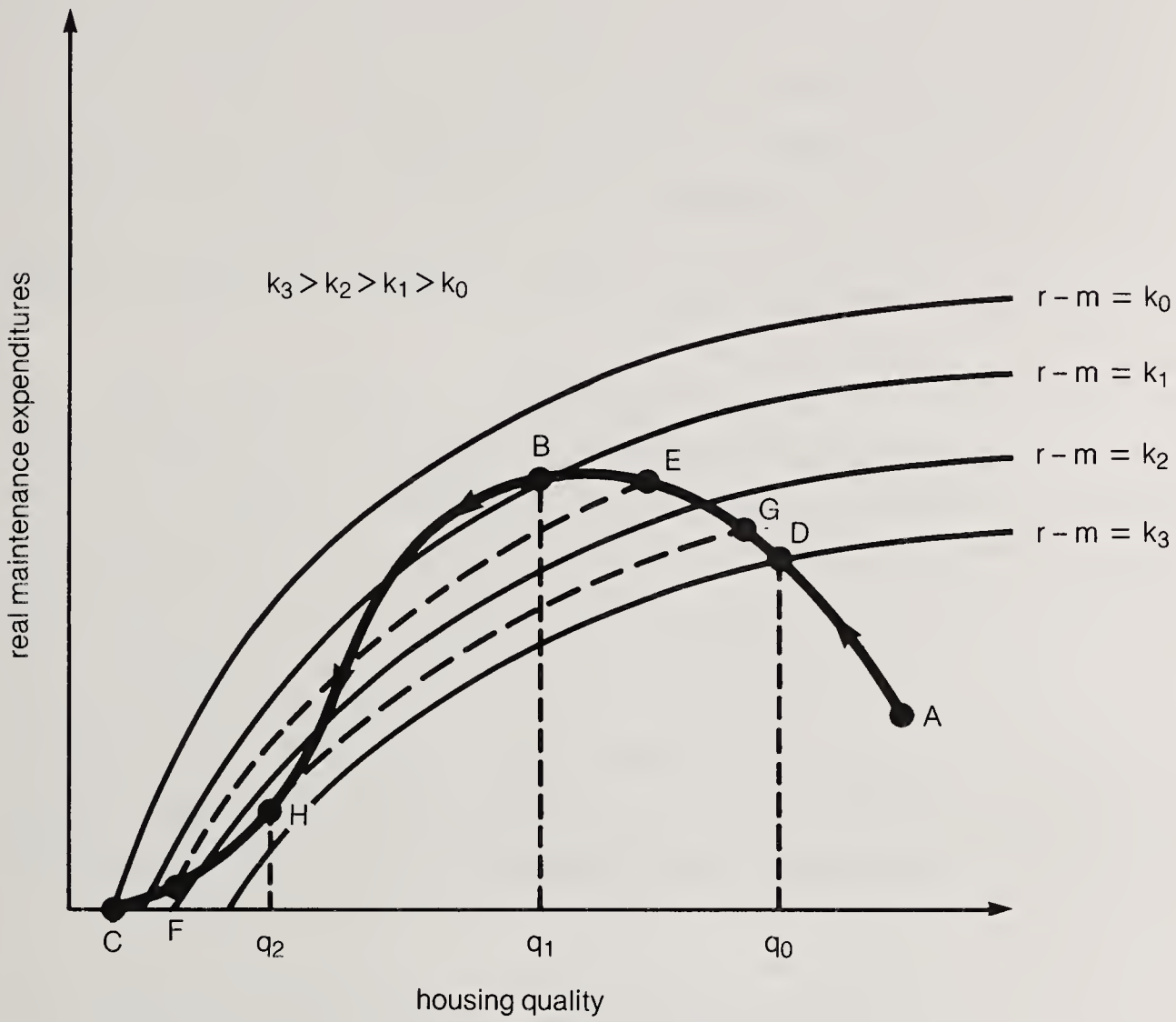
The analysis focuses on the effect of cost pass-through controls on maintenance expenditures. (To simplify the analysis, costs and maintenance expenditures are treated as synonymous.) As before, we study a single landlord's behaviour, inferring the response of the market as a whole.

In Figure 8, ABC is the assumed profit-maximizing path of maintenance expenditures in the absence of controls.[11] Cost pass-through controls are introduced on the building under consideration when it is of quality q_0. The figure also shows several loci along each of which r - m, market-clearing rents minus maintenance expenditures, is a constant. Along any portion of a landlord's path that cuts these loci from below, r - m is falling (maintenance expenditures are rising more rapidly than market-clearing rents). If the landlord's housing is not in excess demand, he will choose not to pass through his entire cost increase; if he did, rent would exceed the market-clearing rent and he would be unable to rent his apartments. If, however, his housing is in excess demand under cost pass-through controls, then he will raise rents by the full amount of his cost increase. Along those portions of a path that cut the r - m = k loci from above, maintenance expenditures are falling more rapidly than market-clearing rents. If cost pass-through controls are in effect, rents must be lowered by at least as much as the fall in cost. If the landlord's housing is not currently in excess demand, movement along such a portion of a path causes it to move into excess demand; if his housing is currently in excess demand, such movement causes the excess demand to increase. Finally, on a portion of a path that travels along a r - m = k locus, rents will be altered by the same amount as the change in costs. Along such a portion of a path, the difference between the actual and the market-clearing rent (which may be zero) is constant.

It is difficult to derive the profit-maximizing maintenance path under cost pass-through. Only the gist of the argument is presented here. First, ABC is no longer the profit-maximizing path. To prove this, com-

11 It can be shown that r - m decreases along ABC near C. Away from C on ABC, however, r - m may be increasing or decreasing. It is possible that r - m decreases all the way along ABC, in which case cost pass-through controls are ineffective.

Figure 8
Pure cost pass-through controls



pare ABC with path AEFC, which takes the same time to travel as ABC. Up to point E, r - m is the same along both paths; after that it is larger along AEFC than along ABC. Hence path AEFC is the more profitable. Second, there is no excess demand along the optimal path. The proof of this is essentially the same as the one just used. Take any path from D to any other point along which there is excess demand; one can always construct another path that is at least as profitable but avoids excess demand. Third, the possibly optimal paths are those that, like DEFC, travel along the optimal path prior to controls for a period of time, then along an r - m = k path until it meets the optimal path prior to controls, and finally along the latter path to C. Which path is in fact profit-maxi-

mizing depends on the interest rate.[12] Given assumption 1 - that the equilibrium rent gradient is unaffected by controls - C remains the profit-maximizing exit point in the absence of excess demand.

A few comments are in order. First, the most remarkable feature of cost pass-through controls is that they never cause excess demand. Second, there appears to be a popular misconception that cost pass-through controls have no effect. This is a possibility (r - m may decrease everywhere along the profit-maximizing path without controls), but that it is not generally the case is evidenced by Figure 8. Whenever there are portions of the profit-maximizing path without controls along which r - m increases, cost pass-through controls are binding.

Third, the effects of cost pass-through controls depend upon the quality of the building when controls are introduced. We have already investigated the effects of controls on a building that is initially of quality q_0. Consider instead a building that is of quality q_1 when controls are imposed. The landlord is constrained to making at most k_1 net rent (r - m) per year on his building. Subtracting depreciation on the building from this gives his economic return from operating the building. This may be less than k_0, which is the opportunity cost of keeping the current building on the site rather than constructing a new one. Thus cost pass-through controls may cause demolition at higher quality levels than is efficient.

Fourth, these controls are inequitable in the sense that they put a ceiling on net rent equal to the net obtained when controls are imposed, which may differ markedly from property to property. A landlord with the building at quality q_1 when controls are imposed can net at most k_1 per year, while a landlord whose building is at q_0 can make as much as k_3.

Fifth, even though the landlord is permitted to increase rents by as much as his costs increase, he may choose not to do so. Along DE in Figure 8, for instance, if the landlord increases rents by as much as his costs, the building's rent will exceed the market-clearing rent for that

12 One suspects that since there is no excess demand, the profit-maximizing path lies as close as possible to ABC subject to satisfying the constraints imposed by controls. 'As close as possible' must, however, be interpreted with care. If the interest rate is very high, the closeness of the path to ABC in the early years will matter far more than the closeness of the path to ABC in later years. Thus the higher the interest rate, the higher is the portion EF of the profit-maximizing path.

quality and he will be unable to rent his units. Thus allowing a landlord a rent increase as large as his increase in costs does not imply that he will necessarily raise rents by this amount. And sixth, pure cost pass-through controls may cause maintenance to fall at some quality levels and to rise at others.

The effects of cost pass-through controls on distribution, tenure conversion, and the volume and quality of new construction are similar to those of guideline increase controls when they cause no excess demand.

MIXED GUIDELINE INCREASE/COST PASS-THROUGH (GI/CPT) CONTROLS

The Rent Review Act and Residential Tenancies Act are not completely clear as to how their guideline increase and cost pass-through provisions are to be combined. However, the administrative interpretation of the acts has generally permitted the landlord to raise rents by the 'maximum allowable' even if his costs have increased by less than this amount. If his costs have increased by more than the allowable rent increase, he may receive a rent increase equal to his increase in costs.[13] Thus Ontario's rent control program closely resembles the program analysed in this section, under which the landlord is allowed to increase his rents by the maximum of either the allowable rent increase or his increase in costs.[14]

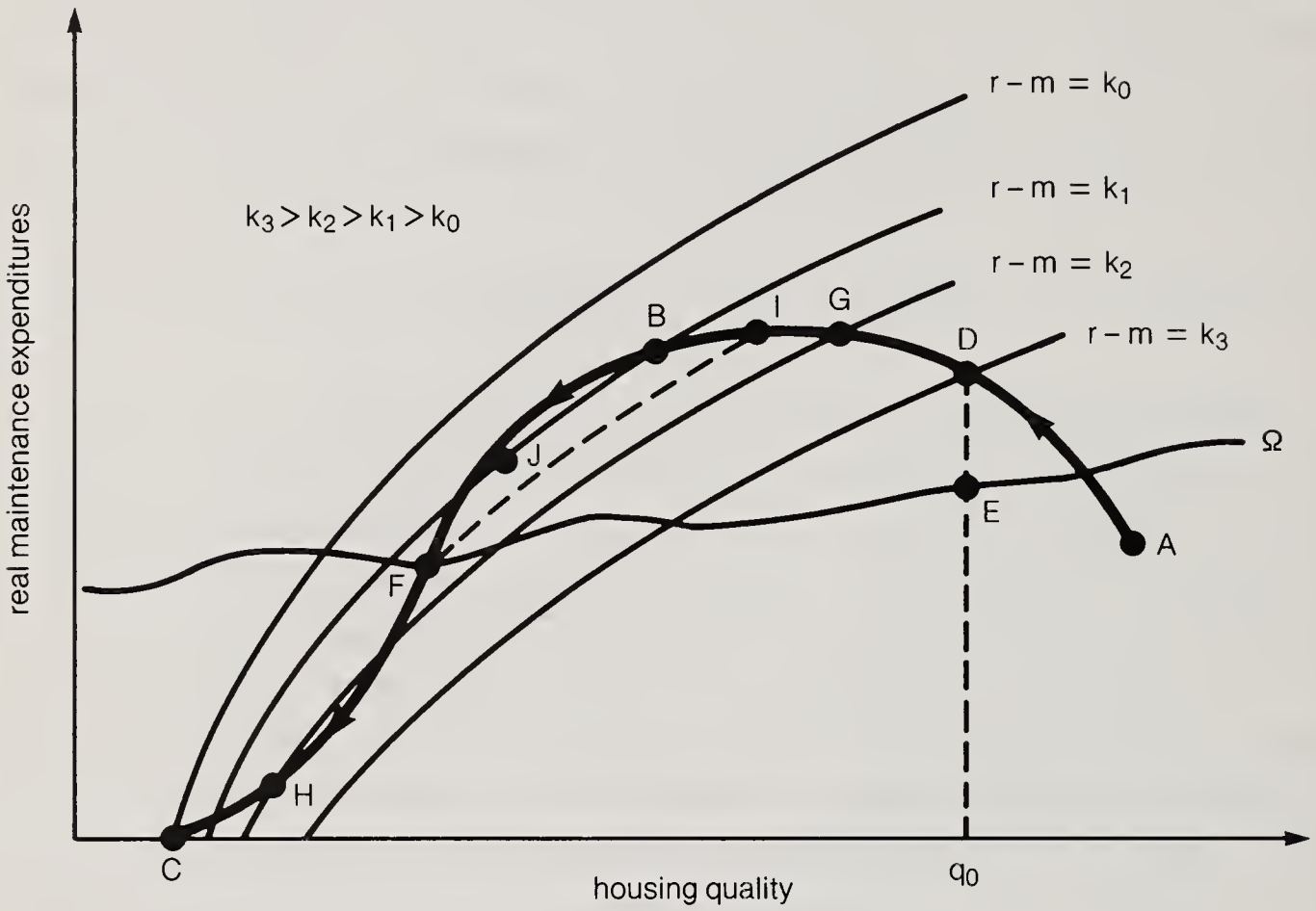
13 The word 'may' is used deliberately. See note 11.

14 The discussion so far has ignored a potential problem. Under GI/CPT controls of the form described, the landlord is able to get a sustained rent increase by spending a lot on maintenance for only a short period of time and then cutting back. What is to prevent this?

Several administrative features of the Ontario Acts preclude such behaviour, or at least make it very difficult to get away with it. First, capital costs are amortized. The sharp but short-lived increase in maintenance expenditures must therefore be for noncapital items. In practice, it is very difficult for landlords to vary such expenditures subtantially. Second, the acts give commissioners discretion for just such reasons. If a landlord pursues such a strategy, tenants will complain the next time he applies for rent review, and the commissioner will disallow his claimed increase in costs. Thus, under the Ontario system, the landlord would only be able to get away with it once. Third, tenants under the current act may apply for rent review if there has been a cutback in the level of maintenance.

One can approximate these institutional constraints by requiring that the cost increase to be passed through be the increase in a weighted average of past costs, with the highest weight being attached to the most recent costs. Such a requirement is implicit in this study's analysis of this form of controls.

Figure 9
Mixed guideline increase/cost pass-through (GI/CPT) controls
(Ω flatter than r – m = k)



This rent control program is more liberal than either pure cost pass-through or pure guideline increase controls, since the landlord can in essence choose which of the two pure forms of controls to operate under; obviously he will choose the one that is to his advantage.

The range of possible qualitative characteristics of a landlord's profit-maximizing path under GI/CPT controls is very large. The example used in the following analysis is, however, one that captures almost all the possibilities. It is shown in Figure 9. The profit-maximizing path in the absence of controls, ABC, is assumed to be the same as in Figure 8, as is the quality level of the building at the time controls are imposed, q_0. The figure shows several r - m = k loci, plus a new locus Ω. On any segment of a path above Ω, market-clearing rents increase by more than the allowable maximum (and below Ω, by less).[15] If only guideline increase controls were imposed, the profit-maximizing path from D to C would be DEFHC,

15 In Figure 7, Ω coincided with DC.

given no excess demand. If only cost pass-through controls were imposed, the profit-maximizing path would be one like DGHC.

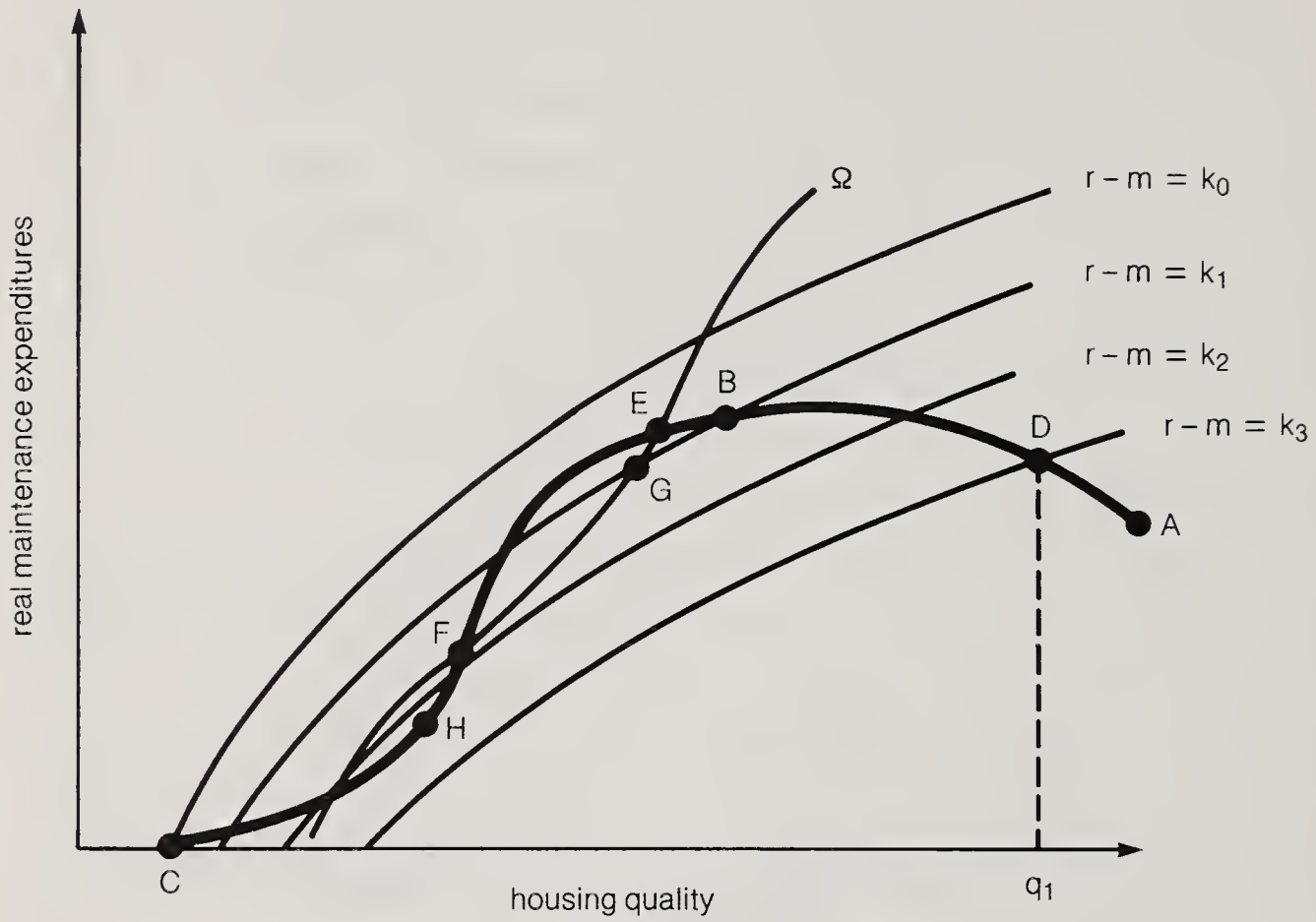
Given GI/CPT controls and no excess demand, DGIFHC is the profit-maximizing path. Again, the landlord can in effect choose which form of controls to operate under, so that GI/CPT controls are nonbinding if either of the pure forms of control is nonbinding. Cost pass-through controls are nonbinding along DGI, and guideline increase controls are nonbinding along FHC; thus mixed controls are not binding in either case. Along IF, however, mixed controls are binding, since here both forms of control are binding. With mixed controls, as with each of the pure forms of control, the profit-maximizing path in the absence of excess demand is the one that both satisfies the controls and is closest to the profit-maximizing path in the absence of controls.

Is it possible to do better than DGIFHC? Perhaps. It may increase profits to take a path such as DGIBJ, then move into excess demand, travel to some point below F on ABC, and finally continue down ABC to C. Thus excess demand is a possibility under GI/CPT controls. Note that when GI/CPT controls do not affect the market-clearing rent gradient, they cause maintenance expenditures at a given quality level either to remain at or fall below what they would be in the absence of controls.

It is heartening that the above model is consistent with almost all aspects of observed landlord behaviour in the Ontario housing market. Some landlords raise rents by less than the maximum allowable; others apply for partial cost pass-through; still others apply for full cost pass-through. Moreover, maintenance on some buildings appears to have been unaffected by controls and on others to have been reduced.

Yet the present form of the model fails to capture one fact of the Ontario program - that a consistently high proportion of landlords apply exactly the guideline rent increase each year. Two explanations for this have been put forward. The first is that many landlords do not apply for cost pass-through because of the nuisance and administrative costs of doing so. The other is that these landlords, having imperfect knowledge of the demand curve facing them, experiment by raising rents by the guideline rent increase. When they find that their tenants do not leave en masse, they do the same year after year. Neither explanation is particularly persuasive. The first might explain the behaviour of small landlords but not of large ones. The administrative costs of applying

Figure 10
Mixed guideline increase/cost pass-through (GI/CPT) controls
(Ω steeper than r – m = k)



for cost pass-through are largely fixed learning costs. For large landlords, the benefits of application, which rise in proportion to the number of units, should exceed their costs. Yet it appears that many large landlords apply exactly the guideline rent increase. The second explanation is weak because it does not indicate why landlords fail to experiment with rent increases of various sizes in the absence of controls.

Modified slightly, the model developed here provides a more plausible explanation. Suppose that the Ω- locus is steeper than the r - m = k curves, rather than flatter as was assumed in Figure 9. This gives the configuration shown in Figure 10; the profit-maximizing path with GI/CPT controls, when they cause no excess demand, is DBEGFHC. On the segment of the path EGF, landlords are raising rents by the guideline increase but are not applying for cost pass-through. The explanation is straightforward. In the absence of controls, landlords would be raising rents by more than the guideline increase, even though their costs would not be rising by as much as the guideline increase; with controls, they

raise rents by the maximum allowable, even though their costs are not rising by as much as the guideline increase. Note that the situation indicated in Figure 10 is also consistent with landlords raising rents by the allowable maximum and not applying for cost pass-through and the building being in excess demand, though in this case the profit-maximizing path would no longer be DBEGFHC. Thus it appears that the model of GI/CPT controls presented here is consistent with the full range of landlord behaviour observed in Ontario's housing market with the current form of controls.

The effects of GI/CPT controls on distribution, tenure conversion, and the volume and quality of new housing are essentially the same as those of pure guideline increase controls.

FURTHER COMMENTS

The discussion thus far has assumed that controls are unanticipated, affecting a landlord's behaviour only after they are applied. If controls are anticipated, the landlord will modify his behaviour before the fact, with a view to reducing the immediate loss associated with their imposition. For instance, if guideline increase controls are in the offing, he has an incentive to upgrade or downgrade his housing during the period before they come into effect, so that by the time they are applied, his housing will be of such a quality that he would not want to raise rents much above the allowable maximum even if he had the choice. If controls are anticipated, then it is the landlords who own buildings at that time who suffer a loss in the form of reduced property values, rather than the owners of these buildings when controls become effective.

The argument has also assumed that controls are applied permanently. Temporary controls cause the value gradient to rotate less (clockwise) than permanent controls; in other words, the value of rental housing declines less if controls are known to be temporary. As a result, maintenance expenditures at every quality level decline less with temporary than with permanent controls. Consequently, a higher proportion of landlords apply for cost pass-through. Also, given two temporary control programs of unequal duration that have been in effect for the same period of time, excess demand will probably be greater in the shorter program, since the maximum percentage increase will be binding on more units.

Rent Control and Options for Decontrol in Ontario

SUMMARY

The theory of the economic effects of rent control is well-developed. If more data were available, one could accurately predict the quantitative effects of a given rent control program. Unfortunately, it is possible at present only to outline the range of qualitative responses to a rent control program. This section has investigated the possible qualitative effects of three stylized rent control programs - a pure guideline increase program, a pure cost pass-through program, and a mixed GI/CPT program that resembles the one currently in effect in Ontario. It was assumed that the programs were unanticipated and of unlimited duration. These were the principal findings:

- While one may assert with confidence that controls hurt landlords, the other distributional effects of controls are ambiguous a priori. They depend on the structure of rents, the maintenance technology, the rationing mechanisms employed, the size and openness of the controlled jurisdiction, and the length of time controls have been in effect.

- The effect of controls on the volume of new rental housing construction is a priori ambiguous and depends critically on whether landlord-builders are persuaded of the government's good faith in promising to exempt housing constructed after the imposition of controls.

- Controls spill over into the owner-occupied housing market in a variety of ways, most obviously by encouraging tenure conversion. They also change the demand for owner-occupied housing (one cannot say a priori in which direction) and this in turn affects both the level of maintenance and the volume of construction of such housing. It also brings windfall gains or equivalent losses to homeowners. As a rule, if tenants are helped by controls, owner-occupiers are hurt, and vice versa.

- Rent control programs with a guideline increase provision cause maintenance expenditures at a given quality level either to remain constant or to fall. On the whole, this type of control discourages maintenance.

- Controls may or may not cause excess demand. The extent of excess demand in a rent-controlled housing market is not a reliable indicator of the impact of controls on the market. The absence of excess demand in a controlled market does not imply that controls are having no effect.

- Landlords operating under guideline increase controls may choose to raise rents by less than the guideline increase. Similarly, landlords operating under cost pass-through controls may choose to pass through less than their entire increase in costs.

- Rent control may cause landlords' book profits to increase in the early years of the program. But these gains are always more than offset by larger (discounted) decreases in book profits later on. Thus the impact of controls on a landlord should be measured not by their effect on his book rate of return, but by the change in the value of his property.

- Empirical knowledge of the housing market is so poor that one cannot obtain even ballpark estimates of the efficiency loss due to controls. When controls are imposed on a small, open jurisdiction and cause no excess demand, the efficiency loss is measured by the fall in property values in that jursidiction. When these two conditions do not hold, the efficiency loss may be smaller or larger than the fall in property values.

- In a housing market without controls, landlords may find it profit-maximizing at some quality levels to raise rents by more than their increase in costs. Thus cost pass-through controls can be effective.

- The model of mixed guideline increase/cost pass-through controls described a program in which a landlord can choose to raise his rents by either the guideline percentage increase or his increase in costs. It predicted a range of landlord behaviour completely consistent with what one currently observes in the Ontario housing market. This suggests that this way of viewing Ontario's rent control program is appropriate, and that the new approach to analysing housing markets adopted here is promising.

- The fact that a large proportion of Ontario's landlords raise rents by the guideline percentage increase is explainable as the profit-maximizing response to the existing form of controls. One need not resort to explanations that refer to imperfect information, transactions costs, or the like.

- The effects of an anticipated rent control program are markedly different from those of an unanticipated program. If landlords anticipate that controls are to be introduced, they will adjust maintenance expenditures and construction volume even before the actual application of controls.

- The effects of temporary controls differ greatly from the effects of permanent controls. In particular, over a given time period, a housing market with temporary rather that permanent controls will exhibit less rapid deterioration of its housing stock and probably more excess demand.

Fallacies

Given these conclusions, it is useful to end the chapter with a brief assessment of some popular fallacies about rent control.

Fallacy 1: controls that cause no excess demand are ineffective. If a price ceiling of $0.25 were placed on a loaf of bread of standard composition, people would queue up for the bread. If the price ceiling were raised to $2.00, the ceiling would be ineffective; there would be no queue and no excess demand. Thus, goes the argument, a price ceiling imposed on a commodity of standard or fixed quality is effective if and only if the ceiling causes excess demand. But if the ceiling of $0.25 were imposed on a loaf of bread without reference to its size or quality, bakers would respond by reducing the size of a loaf or by using lower-quality ingredients. The ceiling might cause no excess demand, but it would be effective in reducing the quality of a loaf of bread. Analogously, imposing an effective rent ceiling on an apartment may induce the landlord to lower quality by so much (by cutting maintenance expenditures) that there will be no excess demand for the apartment. Thus, when a price ceiling is imposed on a commodity without reference to the commodity's quality, the price ceiling can be effective even if it causes no excess demand.

Fallacy 2: controls are an effective way of getting cheap housing for everyone, since they lower rents and involve only a very small budgetary cost. It might appear that rent control, particularly when it is inexpensive to administer (as is the case in Ontario) and causes little or no excess demand (as appears to be the case in most of Ontario), is a cheap way of providing decent housing for all. The budgetary cost is low, and controls involve no visible waste of resources. There are two arguments against this naive and mistaken point of view - one on the cost side, the other on the benefit side.

First look at the cost side. Suppose Ontario were to forbid the importation of bananas. The province would develop a banana-growing

industry, presumably growing the bananas in greenhouses. The budgetary cost would be zero, and the policy might appear to stimulate Ontario's agriculture. However, if the manpower used to produce bananas were instead employed in the growing of wheat, and if this wheat were exported and the foreign exchange from its sale used to purchase bananas on the world market, it would be possible, with the same manpower, to obtain perhaps ten times as many bananas. A policy of forbidding the importation of bananas causes no unemployment of resources, but it does cause an obvious and severe misallocation of resources. Such a situation would be analogous to the one created by rent control. Controls cause too little to be spent on maintenance. Resources that would be most beneficially used in housing maintenance are either employed in another industry or unemployed. This entails a cost that, though invisible, is just as real in welfare terms as a budgetary cost or the physical destruction of resources.

Now look at the benefit side. Rent control may result in everyone obtaining 'affordable' housing, but it cannot result in everyone obtaining decent housing. For the latter to occur, the quality of housing services in the aggregate must expand, but controls usually cause this quantity to contract.

Fallacy 3: controls cause landlords to raise rents to the maximum allowable, which is more than many would have charged without controls. Underlying many supposed economic fallacies is a valid, albeit poorly articulated objection to the unrealism of some assumption underlying the economist's dogma. However, this is probably not the case here. A price ceiling of $10.00 for a loaf of bread would not induce bakers to raise their price to this level; they would continue to charge the market-clearing price. The rent-control situation seems completely analogous. However, Walker (1976, 53) argues that prior to controls landlords may have been charging less than the market-clearing rent, and that controls may encourage them to raise rent to the market-clearing level. Walker suggests that this result, which he calls the 'boomerang effect', could occur because, prior to controls, landlords either did not know the market-clearing rent or else, due to scruples, chose the charge a rent below the market-clearing level. Neither argument is compelling, since most rental housing is owned by informed landlords who have an impersonal relationship with their tenants.

5
Decontrol

The purpose of this chapter is to provide an overview of strategies for decontrol. It begins by using the analytical framework already developed to explore the economic effects of various decontrol programs. This analysis is followed by some observations concerning the politics of decontrol. A third section draws on the previous discussion in outlining the pros and cons of various decontrol programs and the circumstances under which each would and would not be desirable. Finally, the results of the chapter are reviewed in a brief concluding section.

Before beginning, it is necessary to indicate how broadly the term 'decontrol strategy' or 'decontrol program' is used here. A broad definition could cover any program whose effects intersect with those of rent control. Rent control affects rents paid; thus rent subsidies could be treated as a possible component of a decontrol program. Rent control affects the volume and quality composition of newly constructed housing; thus subsidies to construction, capital improvement, and maintenance could be considered as part of a decontrol program. And rent control affects the welfare of different groups in the population; thus redistributive policies generally could be viewed as a facet of decontrol. Here, however, decontrol strategy is defined very narrowly to include only policies that relax a rent control program as such. To consider a broader definition would require a review of all current government programs that concern housing and redistribution, as well as an examination of how a proposed decontrol program would fit into the existing policy structure. This in turn would require an examination of the social philosophy underlying this structure and, finally, the assessment of a bewildering array of options. All this is far beyond the scope of this study. In any case, policies are usually introduced and changed in piecemeal fashion. Decontrol of the

Ontario housing market, if it happens, will almost certainly occur by itself or in conjunction with some marginal changes in subsidy policies, not as part of a grand restructuring of the province's housing and income-redistribution policies. This is particularly true today, when the federal and provincial governments, concerned about balancing their budgets and eliminating waste, are reluctant to commit themselves to additional expenditures.

DECONTROL STRATEGIES - DEFINITION AND ANALYSIS

A decontrol strategy is here defined as the sudden or gradual phasing-out of all or part of an existing rent control program. It makes sense to talk about a decontrol strategy only when the form of controls has been specified. Since the current rent control program in Ontario is essentially a mixed guideline increase/cost pass-through (GI/CPT) program, this chapter treats decontrol in the context of a program of the ideal GI/CPT type as described in Chapter 4.

Types of decontrol strategies

The following pure decontrol strategies have been applied outside Ontario and could be used to decontrol the Ontario housing market.

- Vacancy decontrol. Units are decontrolled as they become vacant.
- Vacancy-rate decontrol. Particular housing submarkets (defined on the basis of the location or type of unit) with a vacancy rate above some statutory level are decontrolled.
- Rent-level decontrol. Rent-level decontrol could be more appropriately termed decontrol from the top down, since it involves decontrolling the most expensive units first and the cheapest last. The rent level above which units are decontrolled can depend on the location or the type of unit.
- Floating up and out. This designation covers any gradual relaxation of controls that applies uniformly across housing submarkets. When controls are of the GI/CPT type, floating up and out entails gradually raising the guideline increase. Where the control program contains a rate-of-

return provision,[1] this kind of decontrol could entail raising the rate of return.

- Contracting out. This is a form of vacancy decontrol; the landlord and tenant negotiate a sum that the landlord pays the tenant if he vacates.

- Local option. A higher jurisdiction that currently administers controls allows lower jurisdictions to choose whether or not to retain them. Usually, the higher jurisdiction requires the lower to administer the controls if the latter decides to retain them.

- Blanket-lifting. All rent-control provisions are suddenly and completely lifted.

These are pure forms of decontrol. A vast array of mixed forms are also possible. Manitoba, for instance, which had a form of controls similar to Ontario's, applied blanket decontrol to all rental units outside Winnipeg and Brandon; in Winnipeg and Brandon, it decontrolled all units renting for $400 or more per month and is decontrolling other units as they become vacant. Thus the Manitoba scheme involves a mixture of the rent-level method, blanket-lifting, and vacancy decontrol.[2]

The following discussion and subsequent formal analysis treat only the pure forms of decontrol, but they could be extended to cover any mixed decontrol strategy.

THE EFFECTS OF DECONTROL: GENERAL DISCUSSION

The factors affected by a decontrol program are usefully separated into five categories: maintenance expenditures, rent increases, construction, efficiency, and redistribution.

1 A rate-of-return provision operates as follows. The landlord computes his book rate of return when the rate-of-return provision is not applied. If this rate of return is less than the rate of return contained in the rate-of-return provision, he can raise his rents to a level that will give him this rate of return.

2 See Appendix B for a more detailed description of Manitoba's recent rent control and decontrol programs.

Maintenance expenditures

It was argued in Chapter 4 that GI/CPT controls cause maintenance expenditures to be reduced at most quality levels. As one would expect therefore, decontrol stimulates maintenance; indeed, anticipated decontrol will stimulate maintenance expenditures even before it is actually introduced. The path of transition from the maintenance path with controls to the long-run maintenance path depends on the form of decontrol and whether or not decontrol is anticipated.

The most obviously stimulative policy is rent-level decontrol. To have their housing decontrolled, landlords have to get their rents above the critical level. They can do this more quickly by increasing maintenance and raising rents via cost pass-through. The effect of this and other decontrol policies on transitional maintenance expenditures will be analysed later.

Rent increases

Different decontrol packages can be expected to have markedly different effects on the timing, magnitude, and pattern of rent increases, since each relaxes controls in a different way across submarkets that may vary considerably in the degree of excess demand present. Unfortunately, because of the complexity of the pattern of excess demand across submarkets under GI/CPT controls and the difficulty of measuring excess demand (no queues develop and no one sleeps in the street), it is hard to do more than roughly indicate the magnitude of the rent increases that would occur with the various decontrol strategies. Blanket-lifting carries with it the danger of large rent increases in certain submarkets. Floating up and out prevents increases above a statutory percentage. Decontrolling from the top down affects the timing of rent increases borne by different groups.

Construction

Chapter 4 argued that the effects of controls on new housing construction are complex, and that little can be said about them *a priori*. The same applies to the effects of decontrol. Under unanticipated blanket decontrol,

for example, the profitability (and hence the volume and quality composition) of rental housing construction depends on the immediate post-control market-clearing rent gradient and how the rent gradient changes in the process of adjustment to long-run equilibrium.[3] Because controls typically reduce the quality-adjusted stock of housing, the postcontrol market-clearing rent gradient normally lies above the long-run equilibrium rent-gradient. Consequently the volume of housing construction will be higher than the long-run equilibrium level but probably lower than it would have been had controls been maintained.[4] If such decontrol makes tenants as a whole better off, the demand for owner-occupied housing will fall, which will retard new owner-occupied housing construction. But the extent to which any of these results follow from blanket decontrol depends on the details of the housing market. The effects of unanticipated, gradual decontrol on housing construction are even more difficult to ascertain, depending as they do not only on the nature of the market, but on the characteristics of the specific decontrol program as well.

The anticipation of decontrol affects the volume and quality composition of housing construction both before and after decontrol begins. Prior to the introduction of decontrol but after its announcement, the landlord-builder realizes that the program will affect the market-clearing rent gradient and hence the profitability of housing construction at the various quality levels. The resulting change in the volume and quality composition of new housing changes the market-clearing rent gradient,[5] and this in turn affects the volume and quality composition of housing constructed after decontrol is implemented.

3 In talking of long-run equilibrium, we have in mind a stationary or steady-state economy.

4 These statements assume that housing constructed after the imposition of controls was exempt from controls, and that landlord-builders believed that the government would not later apply controls to this housing. With decontrol, the quality-adjusted stock of housing increases. This lowers the market-clearing rent gradient, which slows down the rate of housing construction.

5 In a competitive market, the anticipation of decontrol causes the value gradient of rental housing to shift. This gives the signal to atomistic builders to increase or decrease the volume of housing constructed at a particular quality level. Thus every builder need not sit down and compute how decontrol will affect the market-clearing rent gradient. But some builders must perform such an exercise if the value gradient is to shift.

Efficiency

The blanket-lifting mode of decontrol eliminates the efficiency costs associated with controls; thus in the absence or near-absence of excess demand, it is probably the most efficient decontrol strategy. Given significant excess demand, however, the sudden lifting of all controls only reintroduces efficiency costs in other forms. For example, the abrupt and perhaps sizable rise in rents that would follow blanket-lifting in a climate of excess demand could be extremely disruptive, causing tenants to act hastily and inefficiently in seeking alternative accommodation they can afford. Thus, if the housing market is characterized by significant excess demand when decontrol is introduced, gradual decontrol will probably minimize the sum of the efficiency costs associated with the partial retention of controls and those associated with a sudden rise in rents.

Which of the gradual forms of decontrol is the most efficient is impossible to say a priori, but one can point to some differences in the efficiency effects of the various alternatives. First, it has already been noted that doubling the size of a distortion tends to increase the efficiency loss by a factor of about four. Thus vacancy decontrol, which involves retaining full control on some units (and thus a sizable efficiency loss associated with controls) and suddenly lifting controls on others (and thus a sizable efficiency loss associated with a rapid rise in rents), is probably less efficient than floating up and out, which involves modest efficiency losses of both kinds on all units. Second, some decontrol methods are more likely than others to aggravate the efficiency loss associated with diminished mobility. Vacancy decontrol appears to score worst in this category. If it is applied when there is substantial excess demand, a tenant in a controlled apartment will be very reluctant to move, since he would then have to pay the market rent. Finally, the choice of a decontrol strategy affects the efficiency loss associated with undermaintenance. It has already been noted that rent-level decontrol probably stimulates maintenance more, on average, than do other methods.

Redistribution

The redistributive effects of controls were discussed in Chapter 4. The most obvious redistribution caused by controls is from landlords as a group

to tenants as a group. But controls also cause redistribution among types of tenants. One way in which they do this is by changing the quality composition of the housing stock. For example, it was argued in Chapter 4 that, in the short run, GI/CPT controls cause the stock of low-quality housing to rise and that of medium-quality to fall. If the controls do not also cause excess demand, this effect helps poor households and hurts middle-income ones. If the controls do cause excess demand, then redistribution among tenant groups occurs through rationing. First-come, first-served rationing is probably more favourable to the poor than rationing on the basis of respectability or key money. Finally, controls may hurt or help owner-occupiers. In general, if a particular type of tenant is hurt by controls, the corresponding group of owner-occupiers is helped.

Just as rent control may have a substantial redistributional impact, so too may decontrol. The government must decide what pattern of redistribution it wants. Does it want to return to the precontrol pattern of distribution? If so, does it want to offset the gains and losses incurred as a result of rent control? Or does it - perhaps because substantial redistribution invokes political opposition - want to decontrol with as little redistribution as possible? Or does it use yet another criterion to decide on the appropriate nature of redistribution?

Different decontrol packages have markedly different redistributional effects. A sudden, unanticipated lifting of all controls, for instance, results in a windfall gain for the current owners of rental housing.[6] Its initial effect on tenants depends on the extent of excess demand in various submarkets. (There is unlikely to be a systematic pattern to the extent of excess demand by demographic or income group; if there is, it depends on the peculiarities of the jursidiction in question.) Owner-occupiers either suffer an abrupt loss or enjoy a windfall gain. After the immediate effects of decontrol have been felt but before the market has returned to long-run equilibrium, there continues to be redistribution caused by changes in the quality composition of the housing stock and hence the market-clearing

6 If the blanket-lifting of controls were announced in advance, the windfall gains and losses would occur at the time of the announcement. Thus, if the decontrol strategy were announced when controls were imposed, there would be no windfall gains and losses during decontrol. With any unannounced, gradual form of decontrol, the windfall gains and losses occur at the beginning of the decontrol period.

rent gradient. The contracting-out method, to take another example, results in the renters and the owners of excess-demanded rental housing sharing the windfall gain from decontrol. For units not in excess demand, however, the owners get the entire windfall gain.

THE EFFECTS OF DECONTROL: FORMAL ANALYSIS

Three illustrative decontrol strategies are considered here: blanket-lifting, floating up and out, and the rent-level method.

Maintenance expenditures

It will simplify the analysis to make two assumptions: the market-clearing rent gradient is unaffected by control and decontrol (the small jurisdiction assumption[7]), and rent control was expected to last indefinitely - decontrol is therefore unanticipated. Later, there will be some discussion of how the analysis and its results are modified when these assumptions are relaxed.

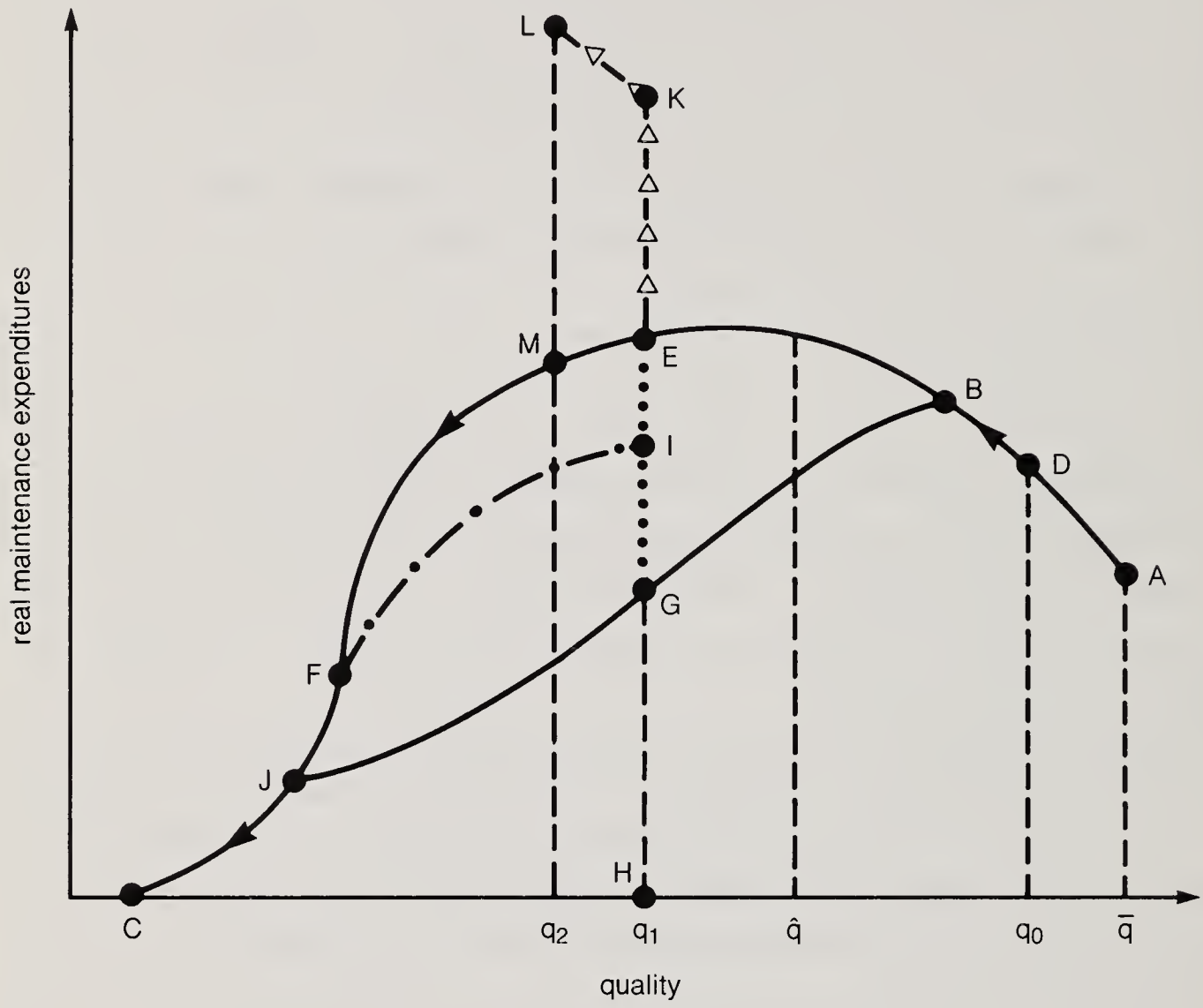
Figure 11 shows: the long-run profit maximizing maintenance path in the absence of controls, ADBEMFJC; the profit-maximizing maintenance path with controls for a building that was of quality q_0 when controls were imposed, DBGJC; and the profit-maximizing maintenance paths that will occur under the three decontrol programs if each is introduced when the building's quality is q_1.

Consider first the blanket-lifting of controls on a building of quality q_1. Upon decontrol, the landlord faces exactly the same maximization problem at this quality level as he would if controls had never been introduced. Thus rents rise to the market-clearing level if there is excess demand or remain at it if there is no excess demand, and maintenance expenditures rise from HG to HE, their level at q_1 in the absence of controls. The blanket-lifting of controls rotates the value gradient of controlled housing counterclockwise, making it steeper at most quality levels, and therefore results in a generally higher level of maintenance.

Under floating up and out, each housing unit is gradually decontrolled. The introduction of decontrol causes an initial sudden rotation

7 It is also assumed that controls are not being applied outside the small jurisdiction.

Figure 11
Decontrol: effects on maintenance expenditures



of the value gradient, reflecting increased future profits; the gradual relaxation of controls thereafter causes further, gradual rotation until the value gradient coincides with the long-run value gradient. This process corresponds to the maintenance path IFJC. The qualitative characteristics of this path are the same whether or not the housing at q_1 is in excess demand at the time decontrol is applied: when decontrol begins, maintenance expenditures immediately rise, but this initial rise is less than it would be with blanket-lifting; however, as controls become less and less strict, the maintenance path moves closer and closer to the long-run maintenance path.

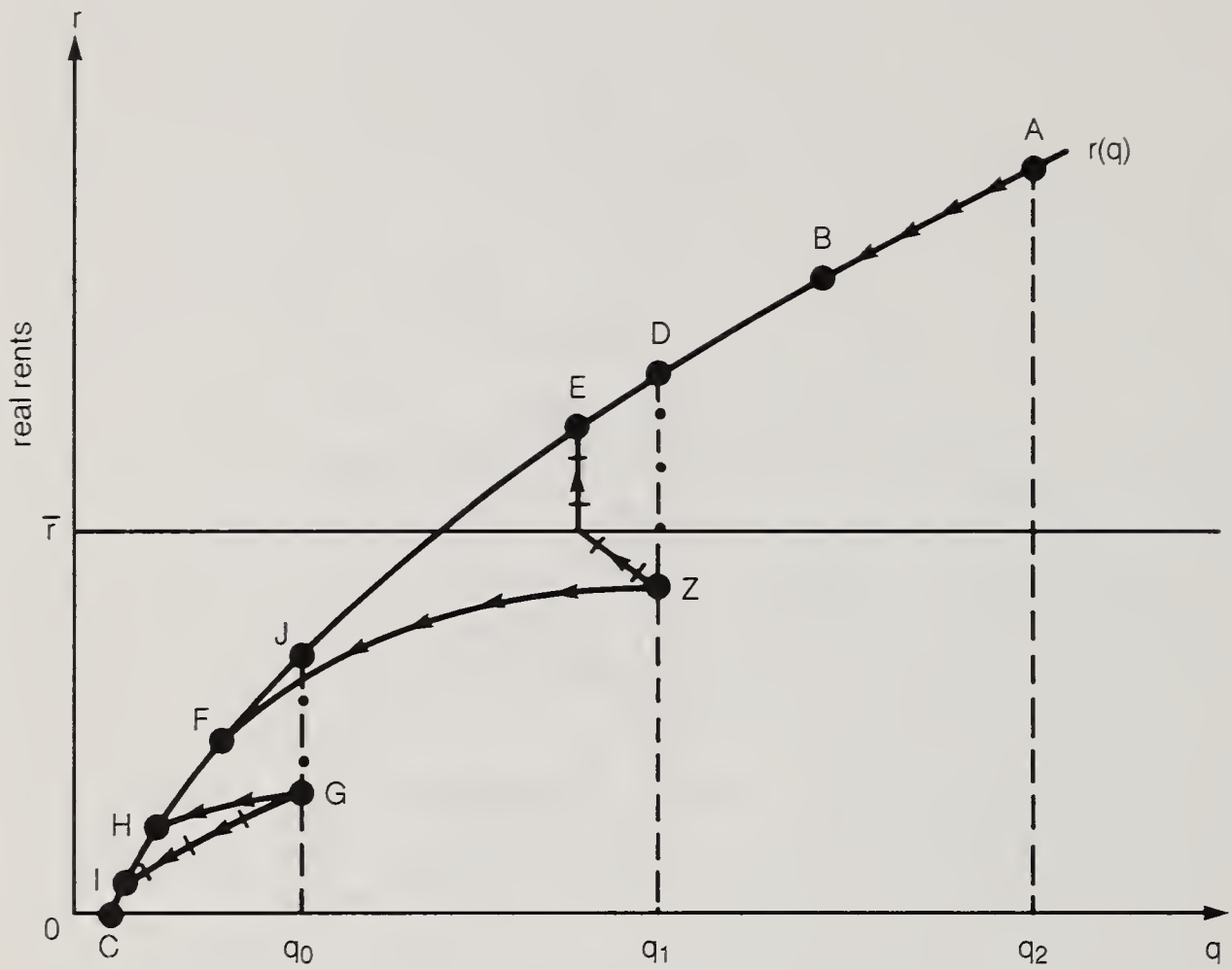
Finally, consider the rent-level method. Suppose that it has the immediate effect of decontrolling all housing above $\hat{q}$, and that, as a result

of inflation, the quality level corresponding to the rent level above which decontrol occurs fall over time. If $q_1 > \hat{q}$, then the building is completely decontrolled when decontrol is applied, and rent and maintenance expenditures rise to the long-run levels corresponding to q_1, as with blanket-lifting. If, however, $q_1 < \hat{q}$, then controls continue to apply to the building during the period immediately after the beginning of decontrol. In the latter case, the landlord has an incentive to spend a lot on maintenance, since this will allow him to raise his rents via cost pass-through and thereby reduce the length of time his building remains controlled. The greater the excess demand for the building and the higher its quality (provided $q_1 < \hat{q}$), the larger is this effect. In the diagram, it is assumed that $q_1 < \hat{q}$ and that the landlord-builder follows the maintenance path GKLMFJC after decontrol is introduced. With this maintenance path, the building is decontrolled when its quality is q_2. Between quality levels q_1 and q_2, the landlord spends more on maintenance than he would in the absence of controls. After controls are lifted from his building, he follows the long-run equilibrium maintenance path.

Now consider how these results are modified when decontrol is announced (or anticipated) before its introduction. If the strategy is blanket decontrol, maintenance expenditures immediately rise part way but not all the way to the long-run level. By the time such decontrol is introduced, however, maintenance expenditures have reached their long-run level. Announcement of the other forms of decontrol also causes maintenance expenditures to rise in anticipation of the increased profitability of maintenance; expenditures then follow paths that are qualitatively the same as the corresponding paths with unanticipated decontrol.

The results of the analysis are also modified when account is taken of the fact that the market-clearing rent gradient is affected by controls. It was argued earlier that in a large housing market, such as Ontario's, rent control causes the number of units of housing service provided by the market to shrink. Thus one would expect the application of controls to a large housing market to push the market-clearing rent gradient up. This should result in the value gradient immediately after decontrol being both steeper than and above the long-run value gradient, which in turn would cause maintenance expenditures everywhere to be higher than indicated in Figure 11. During the transition period after the lifting of controls but before the housing market has returned to long-run equilibrium, the mar-

Figure 12
Decontrol: effects on rents



ket provides landlords with an incentive to 'overmaintain' relative to the long-run equilibrium; this partially offsets the undermaintenance that occurred during the control period.

Rent increases

Figure 12 indicates how rents change in a small jurisdiction after the unanticipated introduction of decontrol measures. The figure gives results for three housing units, which are of qualities q_0, q_1, and q_2 when decontrol is introduced; r(q) is the long-run market-clearing rent gradient. Housing at quality q_2 is assumed to have been constructed after the imposition of controls. Consequently, regardless of which decontrol mechanism is employed, the rent at the time of decontrol and thereafter is the market-clearing rent. At quality q_1, the rent just prior to decontrol is at point Z. Since this rent is below the market-clearing rent for this

quality, $r(q_1)$, there is excess demand. Blanket-lifting results in a sudden increase from the controlled level of rent to its market-clearing level. Floating up and out results in a gradual reduction in excess demand until, at the time controls become nonbinding, the rent path ZF is on the market-clearing rent gradient. Rent-level decontrol specifies that all housing units with rents above $\bar{r}$ are to be decontrolled (to simplify the analysis, inflation is ignored). Housing of quality q_1 is not exempt from controls when decontrol is introduced. However, by increasing maintenance expenditures and passing through the resultant cost increases, the landlord can raise rents to $\bar{r}$.[8] It is assumed that he does so. Once his rents reach $\bar{r}$, his units become exempt from controls and he immediately raises rents to the market-clearing level. This path is ZE in Figure 12. At quality q_0, however, it is not profitable under the rent-level method for the landlord to upgrade his units to become eligible for decontrol. His apartments continue to be controlled, and his rent path is GIC. Determination of the other two rent paths is straightforward. Thus, as one would expect, blanket-lifting results in a sudden increase in rents on all excess-demanded units, rent-level decontrol results in a sudden increase in rents on excess-demanded units above some quality level, and floating up and out causes a gradual increase in rents at all quality levels.

It has already been argued that when decontrol is announced prior to its introduction, landlords increase maintenance expenditures from the time of the announcement. Depending on market conditions, this may or may not cause rents to rise from the time of the announcement. For instance, if it is profitable for the landlord to apply for the cost pass-through, then his rents will rise by the increase in maintenance expenditures.

One can trace the time path of events for the various decontrol strategies in large as well as small jurisdictions. It is only necessary to know that in large jurisdictions the market-clearing rent gradient at the time decontrol is introduced lies above the long-run market-clearing rent gradient. It subsequently moves towards the long-run gradient.

8 It is assumed that the measure of costs employed for the purpose of cost pass-through is some weighted average of past costs. If this were not the case, upon the introduction of rent-level decontrol, the landlord who owned a housing unit whose market-clearing rent was above $\bar{r}$ would immediately raise maintenance expenditures by the amount CD in Figure 12. This would allow him to raise rents by the same amount to the market-clearing level.

Construction

In a small jurisdiction, when new rental housing is exempt from controls and when landlords are certain that the exemption will not be removed, controls have no effect on the volume and quality composition of new housing construction. In these circumstances, decontrol has no effect on construction either. In a small jurisdiction in which either new rental housing is not exempt from controls or landlords fear that the exemption will be removed, controls retard new housing construction but have no effect on the construction of owner-occupied housing. In this case, decontrol and the anticipation of decontrol stimulate rental housing construction but have no effect on owner-occupied housing construction.

The analysis for a large jurisdiction such as Ontario is considerably more complicated.[9] Controls in a large jurisdiction are likely to raise the market-clearing rent gradient. If new housing is exempt from controls and if landlords are certain the exemption will remain in effect, then controls stimulate rental housing construction and the quality composition of such construction changes, though in what way cannot be said a priori. In these circumstances, controls stimulate (retard) owner-occupied housing construction at the same quality levels at which controls make tenants worse (better) off.[10] Upon decontrol, the market-clearing rent gradient moves down towards the long-run rent gradient. Thus decontrol causes the volume of rental housing construction to fall but never below its long-run equilibrium level. Owner-occupied housing construction is stimulated or retarded as decontrol makes tenants worse or better off.

If new housing in a large jurisdiction is not exempt from controls or if landlords fear that the exemption will be taken away, then controls have an ambiguous effect on the volume of rental housing construction. On the one hand, controls tend to raise the market-clearing rent gradient, which in itself makes rental housing construction more profitable. On the other hand, the imposition of controls on new rental housing - or the fear that will be imposed - reduces its expected profitability. In these circumstances, decontrol clearly results in an increase in the volume of con-

9 Despite the large jurisdiction assumption, here and throughout the analysis the interest rate is assumed to be exogenous, and the macroeconomic consequences of rent control and decontrol are ignored.

10 This statement ignores filtering of the owner-occupied housing stock.

struction above the long-run equilibrium level and may result in an increase above the volume that occurred with controls. Again, it is very difficult to predict how decontrol will affect the quality composition of new rental housing.

In a large jurisdiction, the lower the volume of rental housing constructed with controls, the higher is the market-clearing rent gradient on rental housing, the worse off the tenants (on average), and the greater the demand for owner-occupied housing. Thus the application of controls to new rental housing or the fear of such an application stimulates owner-occupied housing construction, while decontrol in these circumstances reduces the volume of this construction, but to a level above the long-run equilibrium volume.[11]

While the qualitative effects of decontrol on the volume of new housing are much the same for each of the various decontrol strategies, the quantitative effects differ. A rule of thumb is this: the faster the decontrol process and the higher the quality of the decontrolled portion of rental housing, the more rapidly the volume and quality composition of all new housing adjust from the level with controls to the long-run equilibrium level. Thus, of the three forms of decontrol under consideration, blanket-lifting is likely to produce the most rapid adjustment to long-run equilibrium. The rent-level method would be next, with floating up and out trailing. Figure 13 shows possible time paths for the adjustment of the volume of rental and owner-occupied housing construction with each of these decontrol strategies. Controls are imposed at time t_0, and decontrol is initiated at time t_1.

An additional point: controls stimulate tenure conversion from rental to owner-occupancy status. Decontrol reverses this process.

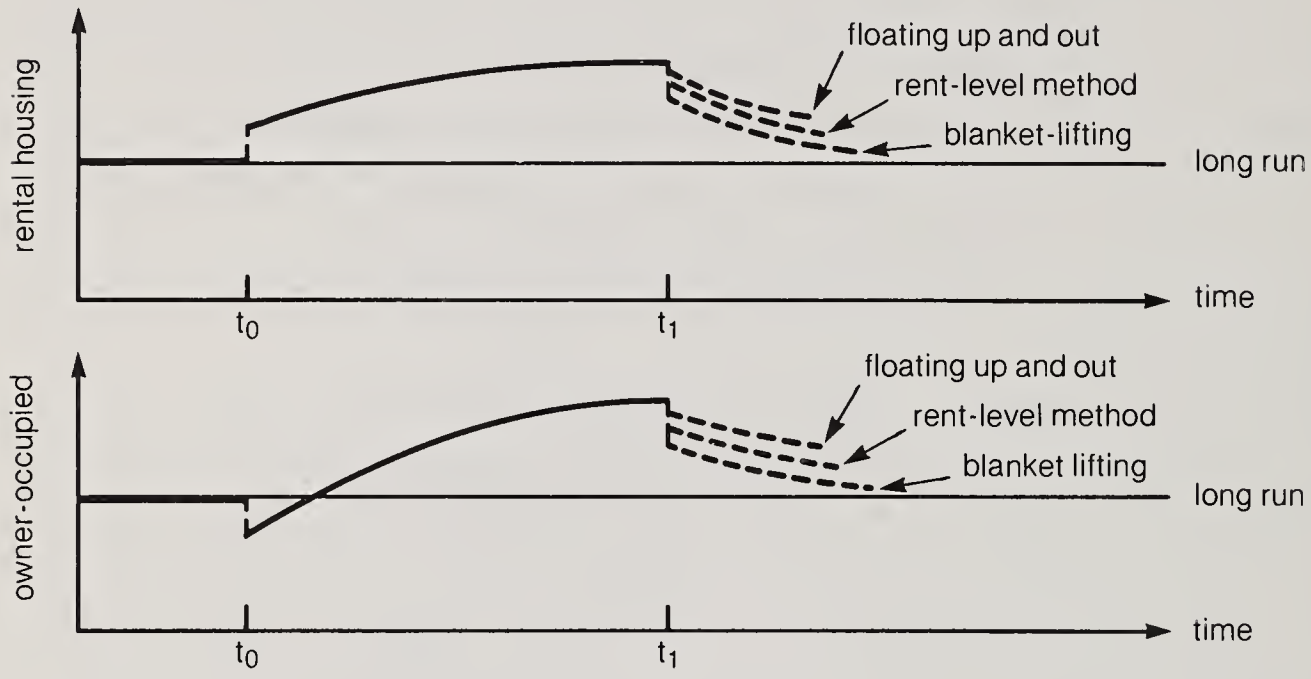
Efficiency

Since all gradual decontrol strategies involve the temporary retention of some measure of control, they can exhibit the efficiency losses associated

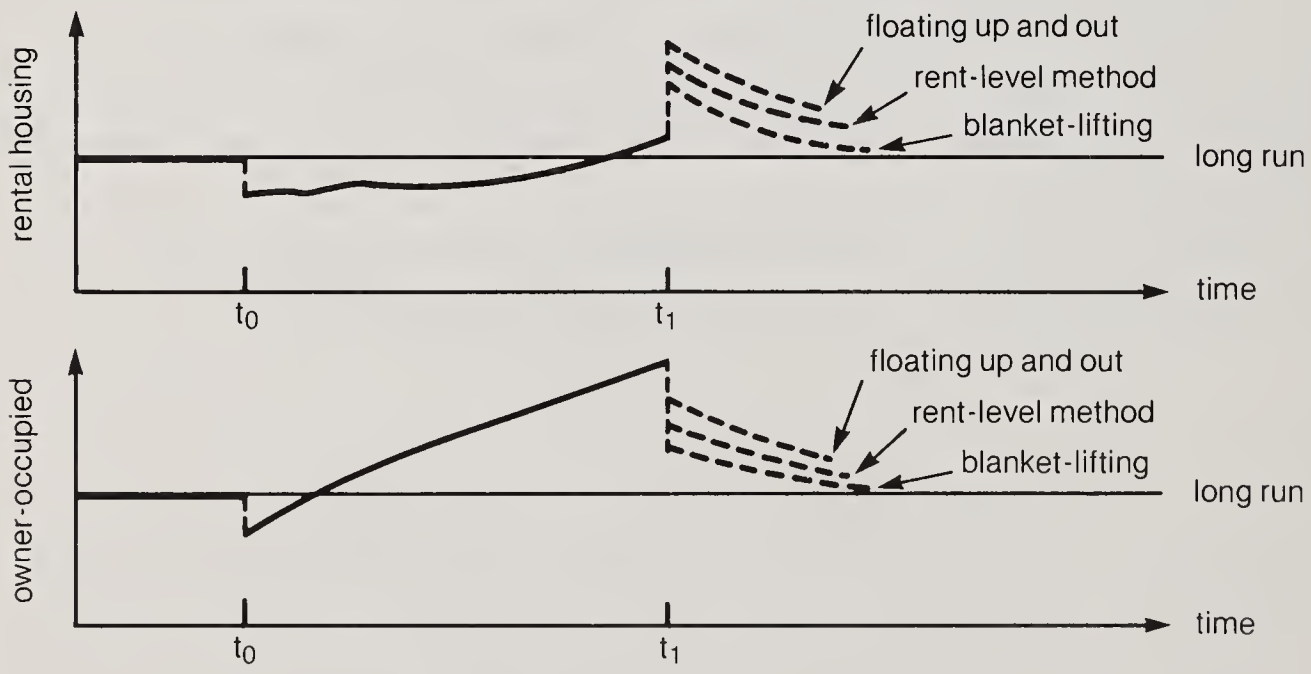
11 This discussion has assumed that landlords are certain that, once decontrol is introduced, controls will not be reapplied. If landlords fear that controls will be reintroduced, the magnitude of the effects discussed above is reduced. Such fear is justified by historical experience. See the description of New York City's housing market in Appendix C.

Figure 13
Volume of new housing construction: two cases

A Landlord-builders believe that housing constructed after the imposition of controls will remain exempt



B Landlord-builders fear that housing constructed after the imposition of controls will not remain exempt



NOTE: Rental and owner-occupied volumes not drawn to same scale

with controls (under-maintenance, inefficient rationing, reduced mobility, etc.) as well as those associated with decontrol as such (the inefficiencies that result from a rapid escalation of rents). Only the sudden ending of all controls - blanket-lifting - wholly avoids the efficiency losses associated with controls. It is impossible to say a priori which of the other two strategies under consideration, floating up and out and the rent-level method, involves more control-induced loss. The efficiency loss associated with decontrol as such is largest with blanket-lifting, of intermediate magnitude with the rent-level method, and smallest with floating up and out. The stricter the control program and the longer it has been in effect, the larger is the efficiency loss associated with the retention of controls. The greater the degree of excess demand in the rental housing market when decontrol begins, the larger is efficiency loss associated with rapid decontrol.

Thus, if there is little excess demand in the market, blanket-lifting is the most efficient means of decontrol, while if there is considerable excess demand, it is the least efficient. The rent-level method is likely to be the most efficient decontrol strategy when there is sizable excess demand at lower quality levels and little excess demand at higher quality levels. The rent-level method stimulates maintenance expenditures on higher-quality housing that remains controlled; via cost pass-through, the rents on these units rise and the amount of excess demand for them falls. Thus the rent-level method can, in the right circumstances, entail only small efficiency losses of both types. Floating up and out is the most efficient strategy when there is substantial excess demand at all quality levels. Finally, it should be noted that when the amount of excess demand present in the various controlled submarkets is highly uncertain, floating up and out is the safest of these three methods of decontrol.[12]

Redistribution

The redistributive effects of decontrol are sensitive to the situation that exists in the housing market at the time decontrol is instituted. It is generally true, however, that decontrol makes landlords better off. More

12 If the government were very worried about the possibility of large rent increases upon decontrol, one could say that floating up and out involves the least certainty-equivalent efficiency loss.

precisely, those landlords who own controlled housing when unanticipated decontrol is implemented enjoy a windfall gain; if controls are announced, the landlords who own such housing at the time of the announcement obtain the capital gain.

If controls create no excess demand, then at the initiation of decontrol tenants become neither better nor worse off - they continue to pay the market-clearing rent. Subsequently, however, decontrol in a large jurisdiction causes the market-clearing rent gradient to fall, which makes tenants better off. Thus in a large jurisdiction in which controls have caused no excess demand, decontrol helps both tenants and landlords. In a small jurisdiction with no excess demand, tenants pay the long-run equilibrium rent with or without controls. An increase in the demand for owner-occupied housing both stimulates its construction and gives the owners of such housing a windfall gain. Thus owner-occupiers benefit from decontrol whenever it stimulates owner-occupied housing construction.

The redistributive effects of decontrol on a rent-controlled housing market with excess demand are considerably more complex; they are sensitive to the rationing mechanism employed and the pattern of excess demand. Little can be said about them beyond what was said earlier in this chapter.

SOME POLITICAL ASPECTS OF DECONTROL

This study's dominant concern is with the economic effects of rent control and decontrol. However, politics plays such an important role both in the decision to remove (or retain) controls and in the choice of a decontrol strategy that some attention must be given to the political implications of the various modes of decontrol. The authors profess no expertise in political science, so this discussion will cover only the most obvious points.

The benefits of rent control are manifest: lower rent for what appears to be the same housing. On the other hand, the costs of rent control are either invisible or not obviously related to rent control. A tenant may blame his landlord for the deterioration of his rent-controlled apartment rather than recognize that reduced maintenance is an inevitable consequence of rent control in a competitive housing market. A pros-

pective tenant who is having trouble finding a rental unit that suits his needs may not realize that the tightness of the housing market is a consequence of rent control. More generally, the concerned citizen may view controls as a way of providing cheap and decent housing for the poor, but he may not perceive the gradual deterioration of the controlled housing stock, or, if he does perceive it, understand that it results from controls.

This point can be combined with three others: that any policy that causes substantial redistribution is politically sensitive; that any policy that results in more losers than gainers is politically dangerous; that the long-term residents of a jurisdiction - usually the greatest gainers from controls - have a disproportionately large share of political power. These observations suggest that rent control is likely to be generally popular (whatever landlords may think of it) and therefore politically attractive even when it is not in the public interest. By the same token, decontrol is likely to be generally unpopular, strongly opposed by long-term residents but supported by landlords, and politically unattractive even when it is in the public interest.

Just as public opinion tends to ignore the more significant results of controls, so it is likely to base its judgement of decontrol on relatively superficial effects. What is of real importance is how decontrol affects redistribution or efficiency. Its effects on rent increases (and for that matter on maintenance expenditures and construction) should be of interest only to the extent that they affect people's welfare. Unfortunately, as we have seen, it is very difficult to ascertain the efficiency and redistributive effects of decontrol, since they are either invisible or difficult to disentangle from other causes of housing revaluation. By far the most visible effect of decontrol is the rise in rents, and it is usually this effect alone that captures the interest of the press and the attention of the public generally. Thus the policy maker who is concerned with the political acceptability of decontrol must give undue attention to rent increases.

These observations provide a basis for conjecture about the political acceptability of specific decontrol strategies. Blanket-lifting is politically the most dangerous mode of decontrol. If there is substantial excess demand, the abrupt lifting of controls causes sudden and sizable rent increases for everyone. The outcry raised by such a result could severely damage a government's popularity and might result in the reapplication of controls. Because the rent-level method causes sudden and

sizable rent increases on more expensive rental units, the degree of political danger associated with its application depends on whether richer tenants respond selfishly or altruistically. If they support the view that the purpose of rent control is to provide affordable housing for the poor, they might tolerate the rent increases. However, if richer tenants respond selfishly, this strategy may encounter substantial political opposition. Clearly, the best way for a government to sell a rent-level policy is to emphasize its fairness.

All the remaining decontrol strategies are politically safer. With vacancy decontrol, no one really views himself as a loser. Existing tenants do not lose when decontrol is introduced, since they continue to pay the controlled rent. Newcomers to the jurisdiction may be disturbed by the high rents on decontrolled housing, but they probably do not blame them on the government. Since rent increases can occur only between tenancies, they do not force anyone to move and so may not be viewed as causing undue hardship. Vacancy decontrol does, however, encourage landlords to harass their tenants to get them vacate, and any such harassment may attract the attention of the press. Vacancy-rate decontrol lifts controls only from submarkets in which there is no excess demand; therefore the rent increases associated with it are generally negligible. This form of decontrol is therefore politically easy, but it is merely cosmetic decontrol - it only lifts controls from those submarkets in which controls are having no effect.[13]

Contracting out is likely to be even more politically attractive than vacancy decontrol. Long-term residents may object to vacancy decontrol, realizing that sooner or later they will want to change units but that doing so will be very costly. Contracting out lowers this cost. However, this policy can result in sizable inequities and perverse incentives, which in

13 Vacancy-rate decontrol may not be totally cosmetic. First, the retention of controls in a given submarket may have an effect at some future date when housing demand in that submarket is stronger. Second, lifting controls in some housing submarkets may stimulate construction in these markets and hence relieve the pressure in other, controlled submarkets (this argument is not very plausible, however, since the high vacancy rates in the decontrolled submarkets are a sign that construction in these submarkets is unlikely to be profitable). Third, it is possible that, in some submarkets with high vacancy rates, controls are binding but landlords are following a low maintenance, no-excess-demand path.

turn can give rise to political problems: landlords have an incentive both to mislead tenants about the market value of their tenancies and to make their lives as unpleasant as possible, while tenants too have an incentive to make themselves objectionable.

Finally, floating up and out causes only modest rent increases and gradual redistribution and is therefore politically attractive.

As a rule, rent control is a hasty expedient, adopted in the face of alarmingly rapid increases in rents. There is rarely much public debate prior to its introduction, nor is it usually much of an issue whether it is announced or not prior to its introduction.[14] The time given to considering the desirability and method of decontrol is normally much longer. For this reason, two related questions about decontrol are important:

- Should a decontrol policy be announced prior to its introduction?
- Should the options be discussed in the public forum before a choice is made?

From the point of view of economics, the answers are straightforward. The announcement of decontrol stimulates maintenance and perhaps construction,[15] gives tenants who will face sizable rent increases upon decontrol time to search efficiently for alternative accommodation, reduces uncertainty, and may (via increased maintenance and cost pass-through) reduce the excess demand in the market. All these effects are beneficial. Whether public discussion of the options is desirable depends on its effect on expectations.

From the point of view of politics, the answers to these questions can only be ambiguous. Announcement prior to introduction gives the opposition time to muster its forces, but it also gives the government time to persuade the public of the desirability of its policy. Public discussion

14 In any event, controls are usually retroactive to a date prior to the announcement of their application.

15 The offsetting effects here have been discussed. On the one hand, if builders have been sure that the government will keep new rental housing exempt from controls, decontrol slows down the rate of housing construction somewhat. On the other hand, if builders are wary of the government's intentions, the announcement of decontrol may make them more certain that such housing will remain exempt.

before the choice of a decontrol strategy may waste time and energy, yet it also gives the government an opportunity to assess public opinion and modify its course accordingly. In the process, the government may gain valuable information about the state of the housing market. In any case, open government is always preferable to closed government.

THE PROS AND CONS OF VARIOUS DECONTROL STRATEGIES

One of the original intentions of this study was to relate the decontrol experience of other jurisdictions to the current situation in Ontario. Unfortunately, most of the material uncovered in the process of exploring decontrol elsewhere provided little hard evidence concerning either the effects of decontrol or the condition of the housing market when decontrol was introduced; what evidence it did provide was so fragmentary and so hard to interpret as to be more or less useless.

The one jurisdiction for which ample documentation was found was New York City, and even New York's innumerable experiments in both rent control and decontrol have received little hard analysis.[16] For this reason, one cannot ascertain the extent to which the moribund state of the city's housing market is due to forty years of rent control, as opposed to such factors as other housing market policies and major demographic changes during the postwar years. Furthermore, because of the significant differences between New York's housing market and Ontario's, it is difficult to say to what extent New York's experience with rent control is relevant to the current situation in Ontario.

We had originally intended to argue in the text that the postwar history of New York's housing market does in fact provide valuable lessons for Ontario - that it shows what the long-term application of controls can do and how difficult it can be to remove controls once they have been in place for an extended period. However, the argument would have been so speculative that we decided instead to relegate the description of New York's experience to Appendix C, allowing the reader to judge for himself its relevance to Ontario, and to downplay its importance in developing our policy recommendations.

16 The Lowry study of 1970 is solid enough, but there is nothing comparable covering the decontrol period of the early 1970s.

The material collected concerning the decontrol experience of several other jursdictions is reviewed in Appendix B. Although severely limited, this material is nevertheless of interest for its description of decontrol strategies used elsewhere. But because so little of direct relevance to the current situation in Ontario can be gleaned from the available evidence on the decontrol experience of other jurisdictions, the following discussion of the pros and cons of various decontrol strategies must proceed on the basis of a priori reasoning. Unfortunately, little can be said a priori about the effects of the alternative methods of decontrol on the volume of construction, the owner-occupied housing market, and the magnitude and direction of redistribution between tenant types. (The theory is available, but it is not possible to make a priori predictions on the basis of the theory.) Consequently, despite the importance of these factors, any decision about decontrol strategy must be based on other considerations, many of which are political in nature.

Vacancy decontrol

The principal advantages of vacancy decontrol are that it is administratively straightforward, causes no disruption to the housing market, and is unlikely to create much political opposition.

Problems often arise in the administration of a regulation because it is complex or ambiguous, because both parties to the regulated transaction have an incentive to collude to circumvent the regulation, or because the regulation creates perverse incentives - that is, incentives contrary to the aims of the regulation. Vacancy decontrol is simple and creates no obvious incentive for collusion. It does create two perverse incentives, but both of these can be handled without much difficulty. First, tenants may try to circumvent decontrol by subletting (at above the controlled rents[17]) without the intention of returning. This can be avoided by permitting decontrol in the event of a sublet, a regulation the landlord has a clear incentive to enforce. Second, landlords have an obvious incentive to harass tenants to get them to vacate - by cutting off electricity and water, for example. A government agency (which in Ontario could be the Residential Tenancies Commission) would have to be set up to rule on

17 Or, equivalently, at the controlled rents, but with a 'consideration'.

tenant complaints and to fine landlords who are deemed to have used harassment.

Decontrol is disruptive when it causes tenants to move as a result of rent increases. The faster rents rise, the greater the disruption, for tenants are given correspondingly less time to find alternative accommodation that suits their needs. Vacancy decontrol causes no disruption of this kind, since the rent increases occur between tenancies.

Long-term residents are unlikely to oppose vacancy decontrol strongly; after all, they can stay in their controlled apartments. New arrivals are likely to accept the post-decontrol rent level and, in any event, are too poorly organized to force a roll-back of rents.

Vacancy decontrol does, however, have two serious drawbacks. First, it creates an even stronger incentive than do strict controls for those in controlled units not to move. With strict controls, while the wait may be long, it is possible to move from one controlled unit to another; with vacancy decontrol, it is not. Thus vacancy decontrol exacerbates the labour immobilty and mismatching of households to apartments caused by rent control. Second, vacancy decontrol is politically expedient but not socially responsible. It discriminates against new arrivals in a way that violates any reasonable notion of social justice. Rent programs are supposedly employed to help the needy, and in-migrants as a group are probably at least as needy as long-time residents.

Vacancy-rate decontrol

Vacancy-rate decontrol may be useful as a component of a mixed decontrol strategy, but when applied in isolation its effects are simply perverse. The vacancy rate is a generally accepted, albeit imperfect, indicator of the excess demand or tightness in a housing market or submarket: the lower the vacancy rate, the tighter the market or the greater the excess demand. Therefore, decontrolling only submarkets in which the vacancy rate is above a particular level essentially means decontrolling those submarkets in which controls are having little or no effect or in which the profit-maximizing maintenance paths involve no excess demand. Those submarkets in which controls are having a pronounced impact and causing excess demand will remain controlled, and this will result in continued deterioration of that housing.

Vacancy-rate decontrol has some attractive features, however, that might warrant its inclusion in a hybrid package. First, it may result in the decontrol of some submarkets in which controls are binding but are causing no excess demand. Second, because it results in only modest rent increases, it is likely to be both nondisruptive and politically easy. Finally, if vacancy-rate decontrol is done on a geographical basis, it permits the dismantling in the decontrolled areas of the machinery that had been required to administer controls.[18]

Rent-level decontrol

There are two arguments in favour of decontrolling from the top down and three, including a strong one, against it.

A common justification of rent control is that it provides the poor with affordable housing. If controls did indeed help the poor and if they were introduced explicitly to aid them, then it would be sensible to apply rent control to low-quality housing alone. The other argument in favour of the rent-level method is that it encourages a substantial increase in maintenance on (and perhaps even the upgrading of) housing units whose rents are somewhat below the critical decontrol rent level.

Two objections to the rent-level method are that it may be disruptive and that richer tenants may oppose it. But it is the third objection that is compelling. In the short run, rent control may help the occupants of

18 Two other arguments in favour of vacancy-rate decontrol are presented here rather than in the text because we consider them spurious or of little merit. First is the domino theory - the idea that decontrolling submarkets with high vacancy rates encourages construction in these submarkets, which will relieve pressure on the controlled submarkets, causing the vacancy rates in them to rise and thereby allowing them to be decontrolled. It is difficult, however, to see how removing controls in submarkets in which vacancy rates are high and controls are nonbinding would stimulate construction, except perhaps by signalling the government's opposition to controls.

Second is the target theory - the idea that decontrolling submarkets with high vacancy rates allows the government to aim stimulative housing-supply policies at the controlled submarkets. This argument is plausible, but the question is whether the Ontario government would be willing to intervene on a sufficiently large scale to raise Toronto's vacancy rate to 4 per cent (which is often cited as a 'normal' vacancy rate - the dividing line between a tight and a loose rental market).

controlled housing, but in the long run controls almost surely hurt them. When controls cause excess demand, tenants pay less than the market-clearing rent. But after the extended application of controls, the market-clearing rent on housing of a given quality is likely to be considerably higher than it would be for housing of the same quality in an uncontrolled market. Moreover, with housing in excess demand, tenants may not get the quality or quantity of housing that they would choose in an unregulated market.[19]

Because, contrary to the intention of controls, their extended application hurts the poor, there are serious political objections to the rent-level method. Since the most ardent advocates of rent control are (misguided) champions of the poor, and since, in an inflationary environment, the rent-level method involves decontrolling successively lower-quality units, opposition to this mode of decontrol is likely to become more and more strident over time. The result may well be pockets of substandard housing that will prove very difficult politically to decontrol. In this situation, the government should provide landlords with subsidies to upgrade their substandard housing. It is more likely, however, that the government will regard landlords as the villains in the case and impose punitive policies, such as stringently enforcing building codes or requiring a certain level of maintenance as a condition for cost pass-through. These measures may, in turn, lead to nonpayment of taxes or housing abandonment - problems to which the government is likely to apply yet another misguided policy, and so on, step by step into the quagmire. A vicious cycle of this sort is a real danger. The British and New York City housing markets are in such a dire state largely because they have fallen victim to it.

Contracting out

Contracting out is similar to vacancy decontrol, but it adds the provision that the landlord and the tenant negotiate a sum that the tenant receives when he vacates his controlled unit. Compared to vacancy decontrol, con-

19 Even if controls do improve tenants' welfare, they also cause a considerable portion of housing to be substandard. Most governments are loath to encourage substandard housing, however cheap it is.

tracting out results in a smaller efficiency loss from mismatching and immobility. However, it has three substantial disadvantages. First, the costs, in time and legal expenses, of landlords and tenants negotiating and disputing settlements are likely to be substantial. Second, it puts the landlord and tenant in a bilateral bargaining situation in which the weaker loses, which is inequitable by most standards.[20] Finally, it adds insult to the landlord's injury; he received a capital loss when controls were imposed, and it seems unfair to require him to give up some of the capital gain he obtains upon decontrol, particularly since this gain will probably not cover his loss (in discounted terms). Housing policy often makes scapegoats of landlords, but in a competitive economy they are, in fact, pawns. To stay in business, they must undermaintain some of their buildings and charge what appear to be unconscionable rents. In other words, they are only the proximate cause of housing market problems; the root cause is the social philosophy underlying our economic system.

Local option

Whether or not the local option form of decontrol is desirable depends to a large degree on whether it is lower or higher levels of governments that are most apt to make wise decisions. Higher levels of governments have better research facilities and staff and can probably administer rent controls - and decontrol - more cheaply. A local government, on the other hand, can be more responsive to the needs of its particular community and more familiar with its problems. In any given situation, one level may be in a stronger position than the others to decide for or against the continuation of controls on the basis of social good rather than political expediency.

Floating up and out

There is a lot to be said in favour of floating up and out. It can be administered using the same institutions that administered rent control; no

20 In order to extract as much of the surplus associated with his relinquishing his tenancy as possible, the tenant will intimate that he intends to remain in the apartment until he dies.

new agencies are required and its implementation is based straightforwardly on precedents set in administering controls. Furthermore, it smooths the path of adjustment from a controlled to an uncontrolled situation, giving tenants who cannot afford their current apartments at market-clearing rents ample time to find suitable alternative accommodation. In addition, it guarantees that there will be no harmful and politically embarrassing 'unconscionable' rent increases, and it satisfies most notions of equity. The major danger with floating up and out is that with the ease of moving from control to decontrol comes the ease of moving back again. If there is a change in the political balance of power, controls may well be reapplied, since they are likely to be politically popular.

Blanket-lifting

The advantage of blanket-lifting is obvious: it eliminates at a stroke what could become a malignant cancer in the housing market. Such precipitate action has its costs, however, and the greater the degree of excess demand in the market, the greater these costs will be. If there is even moderate excess demand in the housing market as a whole, there is probably substantial excess demand in certain submarkets. The sudden and dramatic increase in rents that tenants in these submarkets will experience with blanket-lifting may have serious social and political repercussions. Many tenants will have to find alternative, often unsuitable, accommodation in a hurry, and for some the experience will be traumatic. The press is likely to focus on instances of extreme hardship caused by decontrol, and in response to the resulting clamour of protest, the government may decide, against its better judgement, to reimpose controls. In short, blanket-lifting is an attractive option only if there is little or no excess demand in any housing submarket.

Mixed strategies

As Appendices B and C demonstrate, one can devise a bewildering variety of mixed strategies for decontrol. A well-designed mixed strategy can capture the good features of the pure strategies while eliminating the bad ones. But mixed strategies also imply increased administrative complexity and possible inconsistency. A full cataloguing of mixed strategies would

be tedious and daunting. Therefore only a few examples are discussed here.

As previously argued, the rent-level method suffers from two major problems. First and foremost, its application can result in a pocket of substandard housing that will prove difficult to decontrol and that will, in consequence, continue to deteriorate. Second, large rent increases upon decontrol may cause hardship and enough opposition to force the restoration of controls. On the other side of the balance sheet, the rent-level method stimulates maintenance and, by temporarily retaining controls on low-quality housing, provides at least a short-run extension of relief to the poor. Can a mixed package be developed that captures the advantages of the rent-level method but eliminates its disadvantages? Probably. One could allow the landlords of units whose rents are currently above the rent level to raise rents gradually to the market level. This could be done by applying floating up and out only to these units. Alternatively, and perhaps more simply, one could allow high-rent units to float up and out faster than low-rent units. To eliminate the danger of pockets of substandard, controlled housing, one could announce when decontrol is introduced that blanket-lifting of controls will follow in, say, five years. Such a policy would probably not result in inordinate rent increases on low-quality units at the end of that term: the prospect of complete decontrol would encourage the landlords of low-quality units to increase maintenance expenditures and raise rents via cost pass-through; this, in turn, would reduce the excess demand for such units.

Another mixed approach could be based on vacancy-rate decontrol, which is inadequate in itself because it does not remove controls from those submarkets in which they are having the greatest effect. However, one could eliminate this problem by combining floating up and out in controlled submarkets with a policy that completely decontrolled submarkets with vacancy rates above 5 per cent in the first year, 4 per cent in the second, and so on.

SUMMARY

This chapter compared the effects of various decontrol strategies. After narrowly defining a decontrol strategy as a policy or mix of policies that relaxes controls gradually or suddenly, it made the following points:

- Housing-market theory is developed to the point that, if the data were available, one could predict the quantitative economic effects of various decontrol strategies. Unfortunately, most of the relevant data are not available; therefore it is necessary to determine the pros and cons of alternative decontrol strategies on the basis of a priori arguments.

- The effects of any decontrol policy are sensitive to both the nature of the given control program and the characteristics of the housing market at the time decontrol is applied.

- If landlord-builders are confident that controls will not be applied to housing constructed after controls are imposed, then decontrol will slow down rental-housing construction; it will not, however, bring it down to the long-run equilibrium level. Some decontrol policies will result in a higher level of rental-housing construction than others, but these differences are likely to be small compared to the effect of different decontrol strategies on builders' confidence and expectations. If, however, landlords are unsure of the government's intentions, then decontrol may stimulate rental-housing construction. The effect of decontrol on the quality composition of rental housing is complex, and nothing can be said about it a priori.

- The effect of decontrol on the owner-occupied housing market is complex; about the only thing that can be said a priori is that decontrol encourages tenure reconversion.

- Decontrol stimulates maintenance; some decontrol policies stimulate maintenance at a particular quality level more than others.

- Decontrol helps landlords. Apart from that, one can say little a priori about its redistributive effects. They depend on the extent of excess demand at the various quality levels when decontrol is applied and on the mechanisms employed to ration housing in excess demand, about which little is known.

- The effects of a decontrol policy depend on whether or not the policy is anticipated or announced prior to its introduction.

- Two types of efficiency costs are associated with any decontrol package. The first is the efficiency cost associated with the partial retention of controls; the second is the cost associated with a rapid rise of

rents upon decontrol. The most efficient decontrol policy is the one that minimizes the sum of these costs; which policy will do this depends on the state of the housing market at the time of decontrol.

- The rent increases that occur upon decontrol are sensitive to the pattern of excess demand in the market when decontrol is applied. Some decontrol strategies result in more rapid rent increases than others.

- The voting public usually overestimates the benefits of rent control and underestimates its costs. As a result, a government may face substantial opposition to decontrol even when it is for the social good. Consequently, a government must give close consideration to the political acceptability of alternative methods of decontrol; public opposition to an unfortunate choice could force the reapplication of controls.

- Because the relative economic merits of alternative decontrol strategies are so uncertain (that is, dependent on the state of the housing market at the time decontrol is applied, about which little is usually known), it is perhaps inevitable and not necessarily unfortunate that the choice of a decontrol strategy must be, to a great extent, a political one.

- From an economic point of view, announcing a decontrol policy prior to its introduction results only in benefits. From a political point of view, the issue is not so clear cut. This means, among other things, that a government must decide on the political desirability of public debate on various decontrol options.

- The literature on the decontrol experiences of jurisdictions other than Ontario is useful in indicating what has been tried elsewhere and what some of the arguments were for and against the strategies adopted. However, with one exception, actual decontrol experiences are so poorly documented that they are virtually useless as guides. The one jurisdiction for which adequate documentation is available is New York City, whose housing-market history is so different from Ontario's that its experience is of dubious relevance to the province's situation. As a result, the choice of a decontrol strategy for Ontario will have to be made almost entirely on the basis of a priori reasoning - and political reality.

This chapter also pointed out some of the arguments for and against various pure strategies for decontrol, then concluded with the suggestion

that a judicious mix of decontrol policies may be preferable to any pure policy. But one cannot say a priori which decontrol strategy, mixed or unmixed, is the best; there is no one best strategy. Rather, the value of any strategy depends on the characteristics of the housing market and the political environment to which it is applied.

6
Policy recommendations

In this chapter we provide policy recommendations, drawing on the arguments developed thus far. The first section discusses characteristics of the Ontario housing market that are relevant to the subsequent discussion. The second section evaluates the relative desirability of Ontario's adopting an alternative form of rent control, retaining the present system of rent control with some modifications, and decontrolling the housing market. (In this evaluation, we assume as givens the many other governmental programs that relate to housing and welfare.) Decontrol options are compared in the third section and a choice made among them. The concluding section presents our policy recommendations and reviews the arguments on which they are based.

CHARACTERISTICS OF THE ONTARIO HOUSING MARKET

Ideally, in order to choose a policy for Ontario vis-à-vis rent control and decontrol, one would set up a model of the Ontario housing market and simulate its alternative futures under the various policy options. Given such a model, one could rank the various policies in terms of efficiency and, as well, identify who would gain and who would lose and by how much with each policy. Then the best policy - the one that maximized some weighted average of efficiency and equity gains compared to the status quo - could be chosen. However, as we have pointed out several times, the data required to proceed in this manner are not available.[1]

1 This is not to say that there are no data. An earlier draft of this study surveyed the main trends related to the Ontario housing market (changes in the housing stock, price indexes, demographic changes, and the state of the economy) and the extent and nature of government intervention in that market. However, most of this material is irrelevant to the formulation of a control/decontrol policy and has therefore been excluded from the present version of this work.

Any evaluation of the policy options must rely for the most part on qualitative, a priori arguments and impressionistic evidence.

Moreover, the range of factors that can be dealt with a priori is extremely limited. In the last chapter, we examined the equity effects of various decontrol policies, only to conclude that very little can be said a priori about the distributional effects of either a given decontrol program[2] or decontrol generally, except that decontrol makes landlords better off than they were with controls.[3] The chapter also discussed efficiency losses - a category of effects that does submit to analysis. Two general types of efficiency losses were defined: those associated with the application of full or partial controls[4] and those associated with the increase in rents that accompanies decontrol. The stricter the controls and the longer they are applied, the greater the efficiency loss per unit of time - that is, the greater the impact of controls on the market. The faster rents rise upon decontrol, the greater the efficiency loss due to decontrol. As the following two subsections will show, the absence of relevant data makes it impossible to draw firm conclusions about either the impact of controls on the Ontario housing market or the rate of rent increase likely to follow decontrol in the province. The policy we shall recommend reflects this uncertainty.

2 Except for what is obvious - for example, that vacancy decontrol helps long-term residents of a jurisdiction and hurts new arrivals.

3 With mixed guideline increase/cost pass-through (GI/CPT) controls, very little can be said a priori about the pattern of excess demand in the market and, therefore, about which groups face sizable rent increases upon decontrol. Moreover, who is hurt and who is helped by decontrol depends on the mix of schemes during the controls period to ration rental housing in excess demand; unfortunately, very little is known about rationing schemes and their effects. Finally, the distributional effects of decontrol depend on how controls have altered the market-clearing rent gradient; with the limited data available, little is known about this either.

4 As discussed at length in Chapter 4, they include: 1) undermaintenance and, consequently, a more rapid deterioration of the controlled rental housing stock than is socially efficient; 2) excess demand, which implies several kinds of inefficiency - mismatching of tenants to controlled rental units, reduced mobility, and excessive expenditure on search; 3) adverse effects on the volume of rental housing construction; 4) inefficient tenure conversion.

The impact of rent control in Ontario

How large an impact are controls having on the Ontario housing market? The short answer is that it is very difficult to tell. The analysis given in Chapter 3 indicated that controls of the kind used in the province can have a sizable impact on a market, even when they are causing little or no excess demand, because they may be leading to landlords' cutting back on maintenance by such amounts that the controlled rents equals the market-clearing rents. Thus one cannot determine the impact of controls of the Ontario type solely on the basis of excess demand. However, if they are effective, such controls do cause increased tightness of the market (excess demand), reduced maintenance, or both.

On both points, the evidence is inconclusive. Table 2 shows the vacancy rates in ten Ontario cities for 1975-9. While each city's experience has been different, these data give one the overall impression that vacancy rates have not changed significantly over this period.[5] It is not clear how much tightness these vacancy rates indicate. They are low compared with vacancy rates of the previous decade,[6] and rent control was introduced in 1975 largely because of a perceived tightness in the housing market. But there is no persuasive theory relating vacancy rates to the tightness of the market, and it is quite possible that the relationship between them has changed over the period.[7] All in all, however, the vacancy rates do suggest a reasonably tight rental housing market, a view supported by impressionistic evidence from tenants. How much of this tightness is caused by rent control? Again, it is very difficult to say.

5 Of the nine cities for which data are available for both 1975 and 1979, the vacancy rate has increased in five (London, Ottawa, Sudbury, Thunder Bay, and Windsor), fallen in three (Hamilton, St. Catharines, and Toronto) and remained more or less constant in one (Kitchener). These changes can be explained in terms of the buoyancy of each local economy.

6 See Table A.1 in Appendix A.

7 See Appendix D. There is another problem. Vacancy-rate data for Ontario group together controlled and uncontrolled rental housing units (the latter are those first rented after 1975), yet what is of interest here is the tightness of the controlled housing market only. However, we do know that the rate of rental housing construction in Ontario over the last few years has been low, at least compared to the period 1968-75 (CMHC 1975, 1979), a fact that suggests this problem is not severe.

TABLE 2

Vacancy rates for ten Ontario cities

	1975	1976	1977	1978	Apr. 1979	Oct. 1979
Hamilton	3.0	3.0	4.2	3.5	3.1	1.8
Kitchener	2.3	2.4	2.6	2.6	2.6	1.9
London	2.4	2.5	1.8	2.3	3.8	4.7
Oshawa	---	---	2.3	1.6	2.1	4.1
Ottawa	2.3	2.2	1.3	1.5	2.5	3.5
St. Catharines/ Niagara	2.9	1.3	1.1	1.4	1.6	1.6
Sudbury	1.2	1.5	1.2	7.0	11.4	5.6
Thunder Bay	0.5	0.2	0.3	1.4	1.4	1.7
Toronto	1.8	1.2	1.0	0.8	1.2	1.2
Windsor	3.6	1.4	1.9	3.9	4.6	5.0

NOTE: 1975-8 data give the average of the April and October vacancy rates.

SOURCE: CMHC (1979)

The slackness of the owner-occupied housing market over the past five or six years, compared to the previous five years and in contrast to the relative tightness of the rental market, could be laid to rent control. But it could also be the result of the housing boom of the early 1970s (which resulted in some overbuilding), of high interest rates (which have reduced the affordability of owner-occupied housing), or of the increased attractiveness of rental housing in the face of rising energy costs (such housing is, on average, more fuel efficient and more centrally located than owner-occupied housing).

It would also illuminate the impact of rental control to know how many landlords are applying for cost pass-through and how many are raising rents by the guideline rent increase. Again the available data are inconclusive; they are, however, consistent with the position that controls have had some impact on the market.[8]

8 Some of the relevant data are presented in Chapter 2, note 7; other data are available in the Ontario Housing Market Surveys published by the Ontario Ministry of Housing.

Finally, controls may have had some effect on the volume of rental and owner-occupied housing construction. The volume of such construction has fallen significantly since the early 1970s, but this could be less because of rent control than because of decreased government assistance, higher interest rates, or the end of the baby boom's entrance into the housing market. Besides, as we argued in Chapter 3, rent control may either stimulate or retard new housing construction, so that a fall in housing construction does not, by itself, suggest anything about the impact of rent control.

Thus, while it appears likely that controls have had an impact on Ontario's housing market, this impact has not been so substantial that the changes in the market from 1975 to 1979 could not be explained by other factors. An econometric study of the Ontario housing market over the period in question might provide a more definite conclusion, but such an undertaking is beyond the terms of reference of this study.

A final point. Even if controls are not currently having an obvious strong impact on the market, they could do so at some future date. If inflation were to increase, for example, the 6 per cent guideline nominal rent increase would result in an even larger annual fall in real rents than it does at present. An unanticipated surge in demand, such as occurred in the early 1970s, would have a similar effect. Finally and most importantly, the effects of rent control tend to be cumulative; the efficiency loss associated with the continued application of controls tends to rise as the square of the length of time they have been applied.

Rent increases accompanying decontrol

What rate of rent increases would accompany decontrol? Consider the extreme case of a blanket lifting of controls. There is no accepted method for estimating the rate of nominal rent increase that would result, but an empirical regularity has been observed in uncontrolled markets between the vacancy rate and rate of rent increases. Specifically, the relationship tends to be a hyperbolic curve in which very low vacancy rates are associated with high rates of rent increase, and high vacancy rates with negative rates of real rent increase. If one assumes that the same relationship holds for a controlled housing market at the time of decontrol, then one can use the vacancy rates in various housing submarkets to

predict rates of rent increase that would occur upon decontrol.[9]

Such an exercise is performed in Appendix D. The relationship between the rate of nominal rent increases, lagged inflation, and vacancy rates is estimated for twelve Canadian cities over the period 1963-75. Then, recent values for inflation and vacancy rates are inserted in the estimated equation to obtain a predicted rate of nominal rent increase for Toronto in the event of a blanket lifting of controls. The results suggest that the average rate of nominal increase in rents would not be alarmingly high. But, for a variety of reasons outlined in the Appendix, little confidence can be placed in these results, though the procedure is not without merit. Even if the results obtained by this exercise were more certain, they would provide little comfort, since they say nothing about the rate of nominal rent increase that would occur in specific submarkets.

Ontario's controls are not differentiated on the basis of submarkets. For some types of rental housing in some locales, demand will have been weak in the past few years; in the corresponding submarkets, controls will have had little or no effect. In other locales and for other types of rental housing, demand will have been very strong, and controls will have caused rents to be substantially below their free-market levels. Thus even in a market in which the average increase in rents upon blanket decontrol is modest, there is the danger of substantial rent increases in some submarkets. Given the available theory and evidence, it is not possible to identify which submarkets would have unusually rapid rent increases upon blanket decontrol.

In other words, it is likely, but by no means certain, that sudden decontrol would not cause average rents in Ontario to rise rapidly. Even so, it could well result in alarmingly high and disruptive rent increases in specific submarkets.

Moreover, whether rent increases would be large or small in the years after decontrol would depend primarily on whether landlords and builders,

9 As is pointed out in Appendix D, conventional economic theory throws no light on the issue. It assumes that markets clear instantaneously. If they did, 'tightness' would have no meaning and, with flexible rents, there would be no vacancies. Disequilibrium economics, a branch of economic theory developed recently, does not assume instantaneous market-clearing. But this theory is not yet well developed, and so it is not helpful in this context.

on average, underestimated or overestimated demand. Because there is no way to determine which they would do, little can be said about the likely long-term path of rents after decontrol.

In summary, little is known about either the present effects of rent control or the probable impact of decontrol on the Ontario's housing market. We shall argue later that an appropriate policy vis-à-vis rent control and decontrol should reflect this uncertainty.

CURRENT CONTROLS, NEW CONTROLS, OR DECONTROL

Current controls versus new controls

According to a familiar adage, an old tax is a good tax. The maxim makes three points. First, change is costly: economic agents must spend time and resources to find out how to reduce their liability under a new tax system and then must alter their behaviour accordingly - which is also costly. Second, new taxes create uncertainty: among its other effects, this uncertainty may cause agents to postpone investment decisions. Third, a change of tax regime causes windfall gains and equivalent losses: the losers' unhappiness may create political difficulties for the government, while the winners' gains, because they are unearned, may be viewed as inequitable.

In much the same way, an old regulation is a good regulation. Replacement of an existing rent control program by a new program engenders capital gains and losses. The uncertainty during the transition period probably results in landlords and builders postponing improvements and construction until the dust settles. Both tenants and landlords have to learn the new regulations, and landlords have to redetermine their profit-maximizing strategy and modify their behaviour accordingly. The old administration has to be disbanded and a new one set up in its place. And the administrative interpretation of the new law has to be resolved in the courts, which is a costly process.

Ontario's rent review system is a sophisticated one. It contains a hardship provision plus provisions to encourage maintenance, upgrading, and new construction. It is hard to think of anything a new rent control program could do that modifications to the existing program could not do

just as effectively and with less disruption. If it is decided that rent control should be retained in Ontario but that the present system is discouraging maintenance and upgrading, the cost pass-through provisions could be modified to allow landlords to treat, say, 120 per cent of their actual costs as costs computed for the purpose of pass-through. If it is decided that the present controls are causing too many bankruptcies, the hardship provision could be liberalized. If it is decided that smaller percentage rent increases should be applied to lower-rent units, the legislation could be modified accordingly, and so on.

In other words, we think that anything a new rent control program could do, modifications to the existing rent control program could do at least as well and with less disruption. Therefore the rest of the chapter will consider only Ontario's existing rent control program, with possible modifications, and various decontrol options.

The retention of controls versus decontrol

Most economists view rent control as an unmitigated evil. Our view is more moderate. We think there are circumstances in which temporary controls are desirable. If, for whatever reason, rents are expected to increase rapidly over a short period and then level off or fall, using rent control to smooth the time path of rents can reduce disruption in the market. Such a situation may have prevailed in Ontario in 1975, but it does not exist today.

Again, rent control may also be helpful in reducing inflationary expectations if it is part of a wage and price control package. But rent control alone is unlikely to affect inflationary expectations significantly, and any benefit it does produce is likely to be more than offset by the efficiency cost of setting the price of housing below its scarcity value.

Temporary controls may have other desirable effects. For instance, the apparatus that has been developed in Ontario to administer controls could be used after decontrol to provide various kinds of tenant protection. But the existence of a convenient administrative apparatus is no argument for continuing a temporary program after any usefulness it had is gone.

As for permanent, across-the-board controls, we are not persuaded by any of the arguments in their favour. All their claimed benefits can be

achieved more efficiently and effectively through other policies. To prevent victimization of the tenant by the landlord, the most effective policy would be to provide the tenant with an easy and cheap means of challenging a rent increase before an impartial party.[10] The assurance of affordable and decent housing for all can be achieved through subsidies to builders and tenants. Redistribution can best be achieved through the tax system. The most efficient means to an end is generally one directed specifically to that end. Thus rent control is an effective way to keep down rent increases, but not to protect tenants, improve social justice, or promote redistribution. When an indirect means is used to achieve a given end, there are inevitably undesirable and inefficient side effects. In the case of rent control, they include reduced maintenance, the various inequities and inefficiencies that attend excess demand in the housing market, and possibly a lower volume of housing construction.

The undesirable side effects of controls are not yet very noticeable in the Ontario housing market. This may be the result of the state of the market and the economy during the past five years, of the lax enforcement of controls, or of the short period of their application. However, where controls have been applied for extended periods of time, they have almost invariably had a devastating effect on the housing market. (This is scarcely surprising, since there are good theoretical grounds for the assertion that the efficency loss associated with controls rises as the square of the length of time that controls have been applied.) On the other hand, one could, in principle, design a package of housing policies (including, for example, maintenance and construction subsidies) that would take advantage of the good features of rent control while neutralizing the bad effects. This has not happened elsewhere, though, and there is little reason to believe that Ontario's government is more wise than other governments. Indeed, if serious problems do start to become apparent in the rental housing market, there is a very real danger that they will be incorrectly diagnosed, and that the government will get

10 It might be argued that the provision of such an appeal procedure would in fact constitute a form of rent control. However, what we have in mind is the appeal not of large rent increases that are justifiable on the basis of market forces, but of victimization - a landlord's taking unfair advantage of his market power and raising rents above the market level in order, for example, to exploit an invalid tenant or to force an unwanted tenant to move.

caught in a vicious cycle in which each new policy attacks only the proximate cause of the problems and makes matters worse. Thus the inefficiencies that are but a minor irritant today could become a running sore in years to come.

One might argue that controls should be retained until the problems they are alleged to cause become manifest. However, there are serious objections to this argument. First, the longer controls are in effect, the greater the redistribution that must come with decontrol, and thus the more difficult controls will be to remove. The majority of those who stand to lose from decontrol are long-term residents who are paying rents considerably below the market level, and this group of residents is politically powerful.

Second, the operation of the housing market is very complex; thus, when problems do arise in that market, the government is all too likely to fail to recognize the role played by rent control and to apply remedies that will only exacerbate the situation. For example, it might respond to the rapid deterioration and undermaintenance caused by controls by strictly enforcing building codes or making adherence to them a requirement for rent increases. Both measures would make the ownership of rental housing even less profitable than it is now and might trigger large-scale abandonment. In response to the erosion of the property-tax base caused by controls, the government might increase property tax rates, still further reducing the profitability of owning rental housing. Confronted by a large scale and inequitable difference in rents between the controlled and uncontrolled sectors, it might decide to apply controls to the uncontrolled sector.

Third, there is a degree of irreversibility in government intervention in any market. If, as a result of the problems caused by controls, government intervention in the housing market increases, there is the danger of gradual movement towards almost complete administrative control of housing and destruction of the market.[11]

Fourth, while the temporary application of controls may actually stimulate rental housing construction, their extended application is almost certain to retard it. The longer controls are applied, the greater will be the problems and tensions in the market, the more radical the govern-

11 This phenomenon is apparent in England and the Scandinavian countries.

ment's successive attempts to solve them, and the more uncertain the economic environment in which the builder operates.

Finally, now is a good time to remove controls. Vacancy rates in most Ontario cities are not disturbingly low; decontrol today would cause little disruption and be relatively painless in these areas. Where current vacancy rates are low, as in Toronto, there is little reason to expect them to rise significantly in the near future. Thus, while immediate decontrol of these cities may involve some pain, it would probably be less than would result if they were decontrolled later.

If after controls were lifted there were another unexpected surge in demand that led to an alarmingly rapid rise in rents, controls could be applied again. But they should always be treated as a short-term, not a long-term, policy measure. The benefits from controls fall rapidly after the temporary, unanticipated surge in demand that led to their introduction is over. The costs, meanwhile, rise exponentially. There is, therefore, an optimal time to remove controls, and in Ontario that time is already past.

DECONTROL OPTIONS

Given the need for decontrol, one must consider the relative merits of doing it gradually or suddenly. The issues here are clear cut. Associated with gradual decontrol are efficiency losses due to the partial retention of controls and the danger that, if decontrol proceeds very slowly, a change in the political balance of power might make the harmful reapplication of controls easier. Associated with sudden decontrol is the danger that rents might rise rapidly, which would cause unnecessary disruption and hardship and might also, in the face of protest, lead to the reapplication of controls.

Therefore, as we argued in Chapter 5, sudden decontrol is desirable when rents upon decontrol will rise only slowly, and gradual decontrol is desirable when there is danger that sudden decontrol would cause rapid rent increases. The point was made earlier in this chapter that too little is known about the current state of the Ontario housing market to rule out the possibility of substantial rent increases in certain submarkets if controls were suddenly lifted. Given this possibility, we consider it wise to 'play it safe' and decontrol in a gradual fashion.

The choice then is which method of decontrol should be used in Ontario. Chapter 5 set forth the pros and cons of alternative gradual decontrol policies in general terms. The following discussion evaluates their desirability in the context of Ontario today.

Gradual rent decontrol programs must be weighed in terms of three desiderata - equity, efficiency, and public acceptance:

- Equity has two dimensions. Horizontal equity is the like treatment of like individuals. Vertical equity is the fair treatment of unlike individuals. The application of both concepts is judgmental rather than scientific, since reasonable men may disagree in their notions of fairness and likeness.

- Two kinds of inefficiencies are associated with decontrol. The first are those that stem from the continued application of controls; the second are those that stem from a rapid rise in rents.

- Public acceptance is a pragmatic consideration in the choice of decontrol strategy. The public tends to overestimate the benefits of rent control and to underestimate its costs. Thus there is the danger that public protest against decontrol will result in the reapplication of controls, even when they are not in the public interest. The government must therefore choose a decontrol policy not only on the basis of its fairness, but also on the basis of its appearance of fairness.

Vacancy decontrol

Under vacancy decontrol, rent increases occur only between tenancies, so no one experiences a rapid rise in rent on his current unit. Thus this mode of decontrol causes little disruption and ranks high in terms of acceptability. It has three disadvantages, however. First, it would discourage people from leaving controlled units, for when they did move they would have to pay the market rent on their new apartments. (This would probably not be a very severe problem in Ontario, where the difference between controlled and free market rents is not yet substantial.) Second, it would make it difficult to remove controls completely at some future date, since doing so would result in substantial losses to those still living in controlled apartments. Finally, and compellingly, the scheme

would be horizontally inequitable, since it could result in two identical households paying widely different rents because one has long been resident in the jurisdiction while the other has recently moved to it. Because vacancy decontrol violates our notions of equity, we cannot in good conscience recommend this policy.

Vacancy-rate decontrol

Vacancy-rate decontrol is largely cosmetic (but see note 13 in Chapter 5), since it decontrols only those submarkets in which controls are having little or no effect. If decontrol were popular, applying a cosmetic policy might be useful. But decontrol will be unpopular. Thus, employed by itself, vacancy-rate decontrol would do more harm than good, though little of either. However, as it permits the selective elimination of controls by submarket, it could be usefully employed in conjunction with some other decontrol policy. For example, one could apply floating up and out across all submarkets, then completely decontrol any particular submarket whose vacancy rate rose above a certain level.

Rent-level decontrol

The rent-level method has its attractions. It allows controls to be applied selectively to lower-quality housing, which gives the appearance of a policy designed to provide the poor with decent, affordable housing. Rent-level decontrol also encourages upgrading at some quality levels and this offsets in part the undermaintenance caused by lingering controls. But this scheme has two severe drawbacks. First, it is likely to be accompanied by rapid rent increases, at least within certain submarkets. Second, the rent-level method can make it very difficult politically to decontrol low-rent units; such an action is likely to be interpreted as an action against the poor, even though the retention of controls would cause continued deterioration of the stock of such housing.

For these reasons, we do not advocate the adoption of this form of decontrol by itself. However, as we indicated in Chapter 5, the harmful effects of rent-level decontrol could be largely neutralized by combining it with other decontrol strategies. The application of floating up and out to units with rents above the rent level would avoid large rent increases, and

an announcement when decontrol is introduced that complete decontrol will occur in a few years would eliminate the danger of pockets of controlled, substandard housing.

Contracting out

Contracting out is not, in our view, a viable option. It has been employed in Hong Kong, but the modus operandi of business in that part of the world is very different from that in Ontario. Hong Kong has no convention of fixed prices; rather, people normally bargain over everything. In such a society it is perfectly reasonable for a landlord and a tenant to bargain over how much the former is to pay the latter if he vacates. However, such a procedure would be quite alien to our way of doing business. It would also waste a great deal of time and effort. If contracting out were applied in Ontario, it might develop into a fixed price system in which the landlord would quote both a rent and a price that he would pay to anyone who vacated. Even if such a system did develop, it would not be desirable. In our view, controls hurt landlords unjustly. The contracting-out method of decontrol would add insult to injury.

The local option

Under the local-option mode of decontrol, the provincial government would allow each municipal government to decide whether or not to retain controls. Such a course might be attractive to a government reluctant to make the unpopular decision to decontrol on its own responsibility. Localities could be encouraged to decontrol by a provision requiring them to assume the administration of controls if they choose to retain them. The danger of decontrol on a local-option basis is that many communities might continue to apply rent control even when its costs come to greatly outweigh its advantages. The harmful effects of controls are complex and largely invisible, and small jurisdictions are likely to underestimate them.

Floating up and out

Of all the pure forms of decontrol, we consider floating up and out the most attractive. In the first place, it is probably the most efficient. Because it does not permit large rent increases, it would be unlikely to

cause much disruption. Moreover, it ensures that all housing will eventually be completely decontrolled; therefore the efficiency loss associated with the continued partial application of controls would diminish steadily. Second, because floating up and out would be applied uniformly to all controlled housing, it would not be likely to offend the public's sense of equity. Third, it would decontrol the whole market gradually, and so the redistribution it would cause would also likely be gradual. Finally, it could be administered by the same agencies that administered rent control and on the basis of precedents set during the control period.

Given the high degree of uncertainty about the distribution and extent of excess demand in the various Ontario housing submarkets, there is much to be said for a decontrol policy under which the rate of rent increase is predictable, constrainted not to exceed some statutory maximum. Succinctly, floating up and out seems the safest of the various pure decontrol policies. It is also fair and gives the appearance of fairness.

Floating up and out: a recommendation

Chapter 5 made the point that a judicious mix of decontrol policies is usually superior to any pure decontrol policy in itself. Is it possible to design a mix of decontrol policies that would eliminate the weaknesses of straight floating up and out? An answer may be suggested by examining the weaknesses of floating up and out and seeing how they could be eliminated or mitigated.

Floating up and out does not formally end controls: it simply makes them ineffective. Unfortunately, this means that it is no less simple a matter to restore their effectiveness. Suppose that the form of floating up and out adopted proposes to raise the guideline rent increase annually in 2 per cent increments to 16 per cent. Because the apparatus for the administration of controls would remain intact, effective controls could be restored at a stroke: it would only be necessary to lower the guideline rent increase from 16 per cent to 6 per cent. This possibility would be eliminated if the decontrol legislation specified that complete decontrol was to take place after a certain number of years.

A second weakness of floating up and out is that it may be misunderstood by the general public. If the government were to raise the guideline rent increase to 16 per cent, and a tenant received an increase of this amount, he might blame the government for the rise, not realizing

that if there were no such guideline his rent increase would be greater than 16 per cent. Although 16 per cent seems like a very large amount, with 12 per cent inflation, it corresponds to only a 4 per cent increase in real rents. It seems large only because we have not yet become used to double-digit inflation. This inflation illusion would be reduced if the guideline increase were specified in real terms - that is, by indexing it to the inflation rate. This would make it clear to the tenant that his high nominal rent increase was primarily the result of inflation.

Thus our recommended decontrol policy is floating up and out, with complete decontrol in a few years. This policy is safe, fair, and simple.

We have not advocated combining floating up and out with vacancy-rate decontrol since little would be gained thereby, and since decontrolling different cities at different times would give the appearance of unfairness. Furthermore, published vacancy rates are averages; there is always the possibility that a city with a vacancy rate above the decontrol cutoff may contain submarkets (by type of unit or by neighbourhood) with a low vacancy rate. Neither have we advocated combining floating up and out with the rent-level method, since the latter would give the appearance of unfairness and carries with it the danger that there will still be substantial excess demand for low-quality housing units at the time of complete decontrol. Finally, we have not advocated combining floating up and out with vacancy decontrol (that is, applying floating up and out to vacated units), since this would not eliminate the basic inequity associated with vacancy decontrol.

A couple of peripheral but important points remain to be made about the decontrol strategy we propose. The first concerns tenant security. One positive feature of Ontario's controls is that they have improved tenant security by facilitating the appeal of 'unfair' rent increases. Decontrol should be done in a manner that does not undermine tenant security. The second point concerns the rate of return or hardship provision. Our discussion has assumed that floating up and out would be synonymous with raising the rent increases permitted under guideline increase controls. Given Ontario's controls, floating up and out could also involve liberalizing the hardship provision. We are undecided about the desirability of doing this. If the provision is fulfilling a useful purpose, then perhaps it should be liberalized; if it is being abused, as some claim, it should not be. The Residential Tenancies Commission is in a better position to judge this than we are.

Finally, we attach some numbers to our proposal. These should be viewed as a starting point for discussion, not as an essential feature of our proposal. We propose that, in the first year of decontrol, the guideline rent increase be raised to 3 per cent below the previous year's annual rate of inflation, rounded down, and then raised, in successive years, to 1 per cent below, 1 per cent above, and finally 3 per cent above the previous year's annual rate of inflation, and that in the fifth year the market be completely decontrolled.

We chose these numbers as a compromise between two objectives - keeping rent increases (and the rate of increase of rent increases) at an acceptable level during the decontrol period, and reducing excess demand enough to avoid a sudden jump in rents upon total decontrol. Our proposed numbers result in the real rent per physical housing unit being more or less the same at the end of the decontrol period as at the beginning. Since physical units will be declining in quality throughout this period, the numbers imply an increase in real rents per unit of housing service, which should reduce excess demand.

The major difficulty that we foresee with this proposal is that the public may misunderstand its effects and oppose it without good reason. Specifically, if the government were to allow a rate of rent increase of, say, 3 per cent above the rate of inflation, the public might think that landlords will necessarily apply such a rent increase. One hopes, however, that people will recognize the fallacy. If the government were to allow chocolate-bar manufacturers to charge no more than $1.00 a bar, they would not all suddenly raise the price of a bar from 35¢ to $1.00. Rather, they would continue to charge what they perceive to be the profit-maximizing price. The situation that our proposal would create is analogous. Vacancy rates are not alarmingly low, so it seems unlikely that landlords would choose, except in a few isolated submarkets, to raise rents by the maximum allowable throughout the decontrol period.

SUMMARY

The gist of the argument contained in this chapter is as follows:

- Ontario's current program (with possible modifications) can do anything a different rent control program could do, without the disruption that the introduction of a new program would cause.

- Thus, if controls are retained, it would be better to modify the existing program (see Chapter 2 for suggestions) than to introduce a new one.

- In most cases, a good policy is one that directly addresses its goal. Thus rent control is a good way to smooth changes in rent; it is not a good way to provide the poor with decent and affordable housing or to redistribute from rich to poor.

- Controls should be used for only one purpose: to avoid the sudden, sharp, and disruptive increases in rent that can accompany an unanticipated surge in demand in the rental housing market.

- Builders will respond to a sudden surge in demand by constructing more rental housing, which will eventually lower uncontrolled rents. Thus the benefits of rent control fall rapidly after the initial surge in demand, while its costs (undermaintenance, reduced mobility, mismatching of households to housing units, and so on) tend to increase exponentially.

- Thus, after the initial, unanticipated surge in demand, there is an optimal period during which controls should be imposed.

- The continuation of controls is highly inadvisable: the longer they are in place, the greater the harm they cause, while the harder they become to remove.

- Given how little is known about the current state of the Ontario housing market, it is very difficult to predict how large rent increases would be if controls were suddenly and completely removed. While the average increase would probably not be large, certain submarkets could experience sizable rent increases.

- Sizable rent increases are undesirable both because of the disruption and hardship they create and because the protest they provoke may persuade the government to reimpose controls, even when this would be harmful.

- For this reason, the safest decontrol policy is one that imposes a ceiling on rent increases but nevertheless gradually decontrols the market.

- We advocate such a policy for Ontario; it would involve gradually raising the guideline rent increase until, in the fifth year of decontrol, controls would be eliminated completely.

Our specific proposal is as follows. The Residential Tenancies Act should remain intact (expect perhaps for some of the modifications suggested in Chapter 2), but the guideline rent increase should be raised gradually year by year, from 3 per cent below the rate of inflation in the first year, to 1 per cent below in the second, 1 per cent above in the third, and 3 per cent above in the fourth. Then, at the beginning of the fifth year,rent control should be eliminated, though those features of the Act that improve tenant security should be retained.

Finally, we underscore that the method of decontrol, while important, is secondary to the need to decontrol.

Appendix A
The structure of rent control in Ontario

This appendix provides a more detailed description of Ontario's rent control legislation and the mechanics of its administration than was provided in Chapter 2.

The organization of this appendix is complicated by the fact that the Residential Premises Rent Review Act (hereafter called the Rent Review Act) was replaced in 1979 by the Residential Tenancies Act, yet not all sections of the latter act have been proclaimed. While the administrative procedures under the former act were well established, those under the new act are only in the process of taking root. For this reason, the discussion focuses on the Rent Review Act, although it points out the ways in which the new act differs from the old.

PREMISES SUBJECT TO THE ACTS

The Rent Review Act applied to all residential premises except those specifically exempted.[1] A building in which none of the residential units were occupied as rented residential premises before January 1, 1976 was exempt. Other exemptions included public housing, nonprofit housing, and premises in a hotel, motel, or vacation home rented for a seasonal period not exceeding four months.

The Residential Tenancies Act applies to the same premises as the Rent Review Act. There is, however, a provision that the lieutenant

1 The act defines residential premises as:

(i) any premises used or intended to be used for residential purposes, and
(ii) land used as a site for a mobile home used for residential purposes. (Ontario 1975, s.1(j))

governor in council may make a regulation exempting from rent control premises renting for more than $750 per month. On March 7, 1980, this provision was implemented.[2] However, a landlord cannot exempt a rental unit merely by giving notice of a rent increase to the $750 level. The rent control provisions of the act must be complied with in reaching that level.

OFFICIALS RESPONSIBLE FOR THE ADMINISTRATION OF THE ACTS

Originally, the Ministry of Housing was charged with the administration of the Rent Review Act. However, the initial legislation did not exempt public housing from controls;[3] thus the Ministry of Housing was required both to set rents for public housing and to determine whether the rent increases it imposed were justified. In view of this conflict of interest, responsibility for administering the Rent Review Act was transferred to the Ministry of Consumer and Commercial Relations.

The Rent Review Act provided that rent review officers (RROs) could be appointed by municipalities with the approval of the minister and by the lieutenant governor in council. No municipalities sought this approval, however, so in practice all RROs were appointed by the lieutenant governor in council. An RROs primary function was to determine the permissible increase in rent in any tenancy agreement brought before him to which the act applied. Related functions included declaring void rent increases that had improperly remained outside the review process and reducing rent when services were discontinued during the course of a tenancy agreement. An RROs decision, in the form of an order, was binding on landlord and tenant.

The Rent Review Act provided for an appeal of the RROs order to an independent body, the Rent Review Board. The act required that at least half the board's members be 'persons representative of tenants'; this provision was satisfied by allowing tenants' associations to put forward a pool of nominees from which board members were chosen. Two members of the board, one of whom had to be a 'person representative of tenants',

2 Regulation 168/80, implementing s.134(1)e of the act.
3 The Residential Premises Rent Review Act was passed by the legislature in 1975 (2nd sess.); the exemption for public housing was added in 1976 by the Residential Premises Rent Review Amendment Act, s.5(1).

constituted a quorum. At the conclusion of an appeal hearing, the board could affirm the decision of the RRO or substitute for it any other order an RRO was empowered to make.

The Residential Tenancies Act establishes a Residential Tenancy Commission to implement the act. Appointments to the commission are made by the lieutenant governor in council. Some commissioners are made appeal commissioners; others, one of whom is designated chief tenancy commissioner, sit on the board of commissioners responsible for administering the commission's affairs. The chief tenancy commissioner acts as chairman of the board and chief administrative officer.

The act empowers commissioners to decide most disputes arising from landlord-tenant relationships. Except when a landlord has applied for review of all rents in a building, a commissioner usually first acts as a mediator. If mediation fails or the matter is urgent, he is empowered to hold a hearing. In the case of an application for whole building review, a hearing is held automatically. At the conclusion of the hearing, the commissioner makes an order that is binding on landlord and tenant.

The new act permits commissioner's order to be appealed to a panel that is composed of two appeal commissioners and one member of the board of commissioners, none of whom took part in the making of the order being appealed. The panel is empowered to affirm the commissioner's decision or to substitute for it any order a commissioner is authorized to make.

THE MECHANICS OF RENT REVIEW UNDER THE RENT REVIEW ACT

Several characteristics of the Rent Review Act should be noted at the outset. First, it did not empower landlords to disregard the provisions of leases and raise rents whenever their costs had increased and they thought they could get an order from an RRO. Ordinarily, the act implied, a landlord was entitled to a rent increase only at the commencement or renewal of a tenancy agreement. However, increases during the course of a tenancy agreement were permitted if the lease contained an escalator clause. But whatever the provisions of a lease, the act permitted only one rent increase during any twelve-month period. Finally, the legislation placed controls on the residential unit rather than upon the landlord or tenant. Thus if a tenant left the premises six months after

the last rent increase, the landlord could not raise the unit's rent for another six months. The landlord therefore had no incentive to change tenants quickly, as doing so did not provide further lawful opportunities to increase the rent. Similarly, no adjustment in rent was permitted when a rental dwelling was sold.

A central feature of the Rent Review Act was the guideline rent increase. From April 1976 to October 1977, the guideline rent increase was 8 per cent of the rent last lawfully changed; from the latter date to the repeal of the act, 6 per cent.

Different rules applied depending on whether the landlord intended to raise his rents by an amount less than (or equal to) or greater than the guideline rent increase. If a landlord sought a rent increase at or below the guideline, he had to give the tenant ninety days notice of the desired increase to comply with the Landlord and Tenant Act and give a notice justifying the increase to comply with the Rent Review Act.[4] The tenant could then elect to terminate his tenancy by giving proper notice. Alternatively, he could remain in possession and take no further action, in which case he would be deemed at the end of the notice period to have accepted the increase. Or he could remain in possession and file an application for rent review. Landlord and tenant then had a fifteen-day period in which to agree upon a suitable increase. Failing this, the landlord had to apply for rent review, setting forth the reasons justifying the increase; in this application he could seek an increase in rent greater than that sought in the original notice. Separate application was necessary for each rental unit, even for identical units within the same residential complex.[5] A date for a hearing would be set within thirty days. After the hearing, the RRO could:

4 Notice that both acts had to be complied with (Re Devitt and Sawchyn 12 O.R. (2d)652).

5 When a landlord submitted applications for several rental units in the same building or project, an RRO could decide to hold a common hearing to consider all the applications. On receipt of a single application for rent review, an RRO was empowered to order a landlord to file applications for review of rents of other rental units at the same time. An RRO would normally require that applications for all rental units to be let or relet in the same financial reporting period (typically quarterly) be considered together. Thus it was standard practice for RROs to hold common hearings. However, notices and orders still had to be issued on a unit-by-unit basis, generating a substantial amount of paperwork.

- approve the rent increase sought by the landlord;
- order that the landlord reduce the amount of the increase;
- order that the landlord repay any rent received in excess of the ordered amount;
- order the landlord to reduce the rent payable from the day of the order;
- order the tenant to pay amounts owing to the landlord.

If landlord and tenant did not agree upon a rent increase during the fifteen-day period and if the landlord failed to apply for rent review, the tenant could apply to the RRO for an order declaring the proposed increase void.

A landlord seeking a rent increase in excess of the guideline had to give a tenant ninety days notice of the increase and a notice of justification. An application for rent review had to be made by the landlord at least sixty days before the date the increase was to become effective. Again, each rental unit required a separate application for rent review. The tenant could either terminate the tenancy on receipt of the ninety-day notice required by the Landlord and Tenant Act or choose to remain in possession. In the latter case, if the RRO had not already made an order concerning the rental unit, the tenant had to begin to pay the guideline increase at the time the proposed increase was to become effective. After the hearing, the RRO could follow one of the five courses listed above. If the landlord failed to apply for rent review, a tenant could apply for nullification of the increase.

THE MECHANICS OF RENT REVIEW UNDER THE RESIDENTIAL TENANCIES ACT

Like the Rent Review Act, the Residential Tenancies Act does not permit the landlord to disregard the terms of a lease. Thus landlords ordinarily receive rent increases at the commencement or renewal of a tenancy agreement.[6] As before, however, increases are permitted during the life of the

6 However, unlike the Rent Review Act, (Ontario 1979, s.126(2)) states that a landlord may apply for rent reivew for units that are vacant at the time of application.

agreement if the lease contains an escalator clause. Again, section 124 permits only one rent increase in any twelve-month period.

A landlord must give a tenant ninety days notice of any intended rent increase (s.60(1)) or else the increase is void (s.60(2)). If the landlord seeks an increase in rent of 6 per cent or less, no application for rent review is necessary. However, if the increase sought is greater than 6 per cent, the landlord must apply for rent review. Further, he must apply for a whole building review - simultaneous determination of rents for all residential units in the same building or complex that are to be let or relet within a twelve-month period from the effective date of the first increase applied for (s.126(2)). The application must be made at least sixty days prior to the date that the first increase applied for is to be effective. Unlike the Rent Review Act, the Residential Tenancies Act requires the landlord to file only one application for rent review.[7] However, copies of the application must be sent to all tenants of rental units affected by it. A landlord must then file material supporting his application not less than fourteen days prior to the date of the hearing. The outcome of a hearing is a commissioner's order fixing the maximum rent to be charged for each rental unit under review, the date the higher rents may take effect, and instructions that landlord or tenant pay the other any sum owed by reason of the decision.

The Residential Tenancies Act preserves a tenant's right to dispute a rent increase except when the increase brings the total rent up to the maximum previously approved by the commission (for example, when the maximum rent was set during a whole building review within the previous twelve months). However, it is unnecessary for a tenant to apply for rent review when the rent increase is to take effect less than twelve months after the effective date of the previous increase; he may simply refuse to pay it, as section 129(1) the act provides that a tenant is not liable to pay any amount in excess of that permitted to be charged under part XI.[8] In this case, the increase violates the requirement that there be only one rent increase in any twelve-month period. It is also unnecessary for a

7 Under the Rent Review Act, a landlord had to file separate applications for each unit up for rent review. A common hearing would usually be held (see note 5).

8 If a tenant does pay an increase in excess of that permitted under part XI, an application for a rebate may be made under s.129(2).

tenant to apply for rent review when the landlord seeks an increase above 6 per cent, since in this case the act requires the landlord to apply for whole building review. If the landlord fails to apply, the tenant is again not liable to pay the increase. If, however, both landlord and tenant apply for review of an increase greater than 6 per cent, the tenant's application 'merges' with the landlord's. Thus a tenant's right to apply for rent review under section 127 is of practical use only when a landlord seeks an increase of 6 per cent or less. In this case, a commissioner's order will apply only to the applicant's unit.[9]

COST PASS-THROUGH AND RENT DETERMINATION HEARINGS

In most cases, rent review under the Rent Review Act and the Residential Tenancies Act has been based on the cost pass-through principle, which permits rents on units entering the review process to be increased only to the extent that costs have risen. Pass-through of increased costs has not been automatic, however; both acts provide that it may be applied or not at the discretion of the officials charged with administering the review process. There have been three main exceptions to application of the principle:

- If a landlord proposed a rent increase below the guideline under the Rent Review Act and the tenant applied for review, this rent increase was typically granted even if the landlord's costs had not increased sufficiently to justify it on the basis of cost pass-through.

- Cost pass-through has been nonbinding when the financial loss provisions in either act and the hardship increase provision in the new act (discussed later) have been applicable.

- As explained later, under the Residential Tenancies Act, the cost pass-through principle is not applied in the case of a tenant application respecting an increase of 6 per cent or less.

The rent-determination formulas of the two acts are very similar. It will do to treat the old act first and then deal with the changes under the new act.

9 This discussion draws heavily upon material from the Residential Tenancy Commission (Ontario 1980).

Under the Rent Review Act, a landlord seeking to justify a rent increase was required to provide information about the following:

- all rent increases since January 1, 1974;
- the withdrawal of any service or facility resulting in a reduction in the tenant's use and enjoyment of his unit;
- his operating costs and capital expenses;
- whether he was sustaining, or anticipated that he would sustain, a financial loss in the operation of the building or project.

The first requirement was satisfied by the completion and periodic updating of a rental history form, the rest by a cost-revenue statement and supporting evidence in the form of receipts, invoices, and work orders.

In the cost-revenue statement, the landlord had to provide financial data respecting the building or project in which the rental units under review were located. Actual data had to be provided for annual periods designated Year 1 (the annual accounting period preceding Year 2)[10] and Year 2 (the most recently completed annual accounting period),[11] while estimated data had to be provided for a projected year (the accounting period commencing immediately after Year 2). Projected information would be considered in light of actual costs incurred in Year 1 and Year 2, the degree to which it could be substantiated, and any other information available.

The landlord was also required to set out the 'total net unit basic revenue', defined as the total rent that would have been received in Year 2 had all units been rented, less the rent attributable to vacant units. Revenues derived from services for which a separate change was levied (for example, parking) were detailed separately.

10 As the administrators of the act explained:

Year 1 can vary according to the period of the tenancy:

(i) For expiring tenancy agreements that were in effect for up to one year, Year 1 means the annual accounting period preceding Year 2.
(ii) For other expiring tenancy agreements, Year 1 would be as many years back as the duration of the expiring tenancy agreement. (Ontario 1977, 3)

11 'On a second or subsequent application for units previously reviewed, the rent review officer may accept Year 2 costs based on a minimum of 7 months actual costs with the remaining months projected' (Ontario 1977, 3).

Finally, the landlord had to provide a detailed list of increases in operating costs attributable to residential units in the building or project, setting apart those related to services for which a separate charge was made. Residential operating costs were defined to include management and administrative overhead,[12] insurance, utilities, municipal taxes, maintenance, depreciation on capital expenditures undertaken during Year 1, and interest on loans for operating purposes (Ontario 1977, 4-5).

Capital expenditures for work completed in Year 2 or proposed to be completed in the projected year were grouped into two categories and treated separately from residential operating costs. 'Major repairs and replacements' were defined as capital expenditures needed to maintain the existing level of services to tenants and/or the physical integrity of the building (for example, the repair of a leaking roof). Because the benefit of such expenditures would be received over a number of years, the justifiable cost was an annual write-off related to the repair's estimated useful life; thus the amount would be recovered, in the form of increased rents, over several years rather than in a single year. 'Major renovation and improvements' increased the level of services provided to the tenants and/or increased the value of the building or project (for example, the provision of air conditioning where it was not already provided). For this category of expenditures, a write-off related to the estimated useful life of the improvement, interest paid on borrowed funds, and imputed interest on equity financing were justifiable costs (Ontario 1977, 6).[13]

Increases in interest and principal payments resulting from renegotiated (at-arm's-length) mortgages could, in some circumstances, be passed through.[14] On the other hand, when financing payments ceased through the discharge of a mortgage, an RRO would not normally offset this decrease against increases in other expenses (Ontario 1977, 6-7).

12 Imputed and actual management and administrative overhead costs were permitted only up to 5 per cent of total net unit basic revenue.

13 Note that interest paid on borrowed funds and imputed equity on equity financing were not treated as justifiable costs for repairs and replacements necessary to maintain the existing level of service to tenants and/or the physical integrity of the building. The asymmetric treatment of capital expenditures for 'major repairs and replacements' and those for 'major renovation and improvements' predictably created problems. The line between the two classes of capital expenditures was not at all clear, and landlords had an incentive to claim that any capital expenditure fell into the latter category.

14 The criteria used to determine in what circumstances increases in interest and principal repayments could be passed through were complex

A 'margin adjustment' was also made, taking into account the amount by which actual costs in a period differed from costs projected for the period in a previous application for rent review (Ontario 1977, 10).

The unit basic rent increase (ignoring, for the moment, financial loss), expressed as a percentage, was defined as the total increase in costs experienced and/or anticipated (taking into account the margin adjustment), allowed by the RRO at his discretion, less any decreases, divided by net unit basic revenue, all times one hundred.[15]

When a landlord suffered a financial loss in Year 2 or anticipated suffering a financial loss in the projected year, the Rent Review Act permitted an increase in rent in excess of the amount determined in the previous paragraph. For the purposes of rent review, a landlord experienced a financial loss when his total revenue[16] fell short of 'out-of-pocket' expenses (our term) - that is, when his cash flow was negative. Out-of-pocket expenses included mortgage principal and interest payments, interest payments on funds borrowed to make major renovations, and improvements and operating costs (defined earlier) less depreciation (Ontario 1977, 10). If a financial loss was, or would be, incurred, the rent increase was recalculated treating all or part of the loss, at the RROs discretion, as a cost. The effect was to bring the landlord to, or closer to, the break-even point.

A summary of the method of calculating the unit basic rent increase is given in Table A1. A similar computation determined the permissible increase in the amount a landlord could charge for services for which a separate charge was levied (Ontario 1977, 10). Adjustments were made for

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but logical. Generally, increases in interest payments were permitted when they resulted from an increase in the mortgage rate but not when they were caused by an increase in principal (except that, when funds were reinvested in the building for an improving capital expenditure, the interest payment might be considered as part of a capital expenditure). Increases in principal repayments were not permitted when they resulted from a shortening of the amortization period.

15 This formula is not exact; some aspects of the discussion in the text are imprecise or incomplete. The reader is referred to the Guide to the Cost Revenue Statement (Ontario 1977) for a more complete treatment of the rent determination formula. In any case, the high court has held that, while an RRO must consider the formula and the Guide to the Cost Revenue Statement, he is not bound by either (Re Minto Construction and the Queen 15 O.R.(2d)15 at 19).

16 Including revenues received from services for which a separate charge was levied.

Appendix A

TABLE A1

Computation of unit base rent increase in Ontario

1	Increase (decrease) in allowable operating costs (excluding those related to the provision of services for which separate charges were levied).	_____
2	Increase (decrease) in annual write-off of allowable capital expenditures (major repairs and replacements and major renovations and improvements).	_____
3	Increase (decrease) in interest on borrowed funds, used to make major renovations and improvements, and deemed interest on equity financing for the same purpose.	_____
4	Increase (decrease) in allowable financing payments (mortgage interest and principal).	_____
5	Margin adjustment.	_____
6	Financial loss or zero, whichever is greater.	_____
7	Total allowable increases (sum of 1 through 6).	_____
8	Total net unit basic revenue.	_____
9	Unit basic rent increase as a percentage (7 divided by 8 times 100).	_____

any changes in the service provided and/or the method of charging for them.[17]

Rent determination hearings were conducted as informally as possible, although the RRO had powers under the Public Inquiries Act (1971) to administer oaths and take sworn evidence. Landlord and tenant, or their

17 The provision of a new service or improvement of an existing service included in rent were treated as increases in allowable costs in determining rent. In the first year of a change in service from included-in-rent to separately charged, it was required that the unit basic rent be reduced by the amount of the charge. No account was taken, at least formally, of the reduction in quality of an included-in-rent service. The treatment accorded discontinuation of a service is discussed later in this appendix.

representatives, were expected to be present at the hearing; if neither party was represented, the RRO was empowered to make a decision based on the information already filed with him (the cost revenue statement). At the beginning of the hearing, the RRO advised both parties of the hearing's purpose, their rights and obligations, and the provisions of The Landlord and Tenant Act, over which he had no jurisdiction. Next he established whether the proper notices of rent increases had been given and the application for rent review made in time. If they had been, then the landlord was invited to discuss his cost revenue statement. The RRO checked the details of the statement and invited questions and comments from the tenants. The RRO made known his decision, in the form of an order, several days after the hearing.

Under the Residential Tenancies Act, as explained earlier, the factors considered in a landlord-initiated whole building review differ from those considered in a tenant-initiated review of an increase of 6 per cent or less. The formula for rent determination in whole building review is broadly similar to the formula employed under the Rent Review Act. However, the Residential Tenancies Act eliminates the distinction between improving ('major renovations and improvements') and nonimproving ('major repairs and replacements') capital expenditures. An annual write-off related to the expected useful life of a capital expenditure made in Year 2 or to be made in the projected year is a justifiable cost.[18] So too is the interest associated with such a capital expenditure. The interest on borrowed funds allowed is the actual or anticipated rate to be paid. On equity funds, the deemed interest rate for expenditures already made is equal to the conventional mortgage rate at the time the work was completed, while for work yet to be completed a 'reasonable' rate is allowed (Ontario 1979a, 5-6).[19]

18 The definitions of accounting periods are slightly changed. Year 2 is the most recently completed annual accounting period. The projected year is the annual accounting period following Year 2, while Year 1 is the annual accounting period immediately preceding Year 2 (Ontario 1979a, 3-4).

19 Also, when past rent increases have not fully reflected capital expenditures made in periods prior to Year 2 (for example, if a capital expenditure was made part way through Year 1), the uncompensated-for portion is now claimed as a capital expenditure rather than as an operating cost.

Appendix A

As noted earlier, the provision for financial loss is more generous under the Residential Tenancies Act.[20] A landlord suffering a financial loss may receive an additional increase to raise gross revenue to 2 per cent above the costs used in calculating financial loss. Furthermore, if there is no financial loss but revenues do not exceed costs in the financial loss calculation by 2 per cent, a 'hardship' increase may be permitted to raise gross revenues to an amount 2 per cent greater than costs (Ontario 1979a, 9). However, when a commissioner decides to eliminate only a portion of a financial loss, an additional hardship increase is not allowed (Ontario 1979b).

In determining rent increases, a commissioner is also empowered to consider changes in the standard of maintenance and repair in the building and rental units. A deterioration in the standard of maintenance occurs when a landlord eliminates or substantially reduces a service and may be reflected in the total rent increase permitted (Ontario 1979d, 1). An obvious problem is deciding if, in fact, the standard of maintenance has deteriorated. However, when a deterioration is shown to have occurred, then either a larger or a smaller rent increase than would otherwise be justified may be appropriate. If the commissioner is satisfied that the landlord is financially unable to maintain the previous standard with current revenues, he may permit an increase in the total rent sufficient to enable the landlord to carry out a higher standard of maintenance. In such a case, the commissioner's order will require the landlord to increase maintenance expenditures. However, if the landlord is financially able to maintain the standard of maintenance but chooses not to, a decrease in the total rent increase justified is appropriate (Ontario 1979d, 1).

Once the total rent increase justified is determined, section 131(4) of the Residential Tenancies Act requires that the amount be apportioned among individual units subject to review. The commissioner is permitted to consider:

20 The definition of financial loss has also changed slightly: 1) there is no need to adjust total operating costs to exclude depreciation relating to capital expenditures made part way through Year 1, as such depreciation is no longer an operating cost (see note 19); 2) the margin adjustment (positive or negative) is also included (Ontario 1979a, 8).

1. The rent schedule proposed by the landlord in his application.

2. Variations, and the reasons therefor, in the rents being charged by the landlord for similar rental units within the residential complex.

3. Rents and variations in the rents being charged by other landlords for similar rental units situated in similar residential complexes within the same geographical vicinity. (Ontario 1979e, s.131(4))

If the total monthly rental revenue permitted by the commissioner is less than the sum of the monthly rents proposed by the landlord, each of the landlord's proposed rents is multiplied by the ratio of the former to the latter to determine the maximum chargeable rent for each unit; that is, an equal percentage increase is applied (Ontario 1979a, 9-10). If the increase sought by the landlord is less than the justified increase, the commissioner defers to the proposed rent schedule.

But because the commissioner's objective is to achieve an equitable distribution of the total rent increase (Ontario 1979c, 1), he may modify the rent distribution (or relative rent distribution) proposed by the landlord if rents for similar units within the complex vary or if rents differ from rents for similar units in other complexes in the same geographical vicinity. The existence of variations in rents between similar units in a building does not in itself justify equalization. Equalization is not in order when similar rental units bear different rents because rents vary from floor to floor or because some locations on a particular floor are more desirable than others (Ontario 1980b, 4). But if the rent of a unit is 'too low' because, for example, rent review began when the unit was the subject of a long-term lease, equalization is justified. Yet how the 'rents for similar units in complexes located in the same geographic vicinity' criterion is to be applied is problematic, given that the act fails to define either 'same geographical vicinity' or 'similar rental complex'.[21] Moreover,

21 But 'Rent Review Guideline RR-10' (Ontario 1980a, 4-5) proposes that an acceptable definition of geographical vicinity is 'an area which shares common facilities such as parks, schools, recreation and transportation facilities', while the similarity of rental complexes 'would be determined both by the characteristics of the complexes themselves such as the amenities provided and the age and size of buildings as well as by external factors such as location within the geographical vicinity and the proximity of any particular residential complex to transit and other facilities'.

the commissioner acts only as an adjudicator/mediator, and the onus is therefore upon landlord or tenant to bring forward evidence to establish the similarity of rental complexes in the same geographical vicinity and to establish that dissimilar rents are being charged for comparable units. In assuming that equalization is justified by intrabuilding and/or interbuilding comparison, the act nevertheless does not require equalization to occur in a single review. As a matter of fairness, however, those tenants who have been paying less for equal accommodation may be expected to absorb a higher percentage rent increase than other tenants. However, the act does not appear to authorize a commissioner to reduce a rent below that currently being paid (Ontario 1979c, 3).

In the case of a tenant's application for review of a proposed increase of 6 per cent or less, the Residential Tenancies Act (s. 132(1)) states that the commissioner should consider only the following factors: variations in rents being charged for similar units within the building/complex and for similar units in similar complexes in the same geographical vicnity, and changes in the standard of maintenance and repair affecting the unit. Note that no reference is made to financial information. In contrast, the Rent Review Act called for an assessment of financial information with respect to both landlord and tenant applications. The thrust of a tenant's application under the new act is therefore that the proposed increase is 'unfair', rather than that it is unjustified because the landlord's costs have not risen.

DISCONTINUATION OR REDUCTION IN THE QUALITY OF A SERVICE

The Rent Review Act defined rent broadly as:

> ...the amount of any consideration paid or given or required to be paid or given by or on behalf of a tenant for the occupancy of residential premises and for any service, privilege, accommodation or thing that the landlord provides for the tenant whether or not a separate charge is made for such service, privilege, accommodation or thing. (Ontario 1975, s.1(1)h)

The act provided that the actual or intended discontinuation of a service, privilege, accommodation, or thing (hereafter, 'discontinuation of a service') supplied by the landlord to the tenant would be deemed a rent increase and considered at a rent determination hearing (s.9).

If any service was discontinued during a tenancy agreement, the tenant could apply at any time to an RRO for a 'discontinuance hearing'. At such a hearing, the RRO would consider whether:

1. a service was discontinued as distinct from a reduction or deterioration in quality; and

2. the service, if discontinued, resulted in a reduction in the use and enjoyment of the residential premises. (Ontario 1977)

If both conditions were met, the RRO would order a reduction in the tenant's rent, under section 11(d) of the act.

The Rent Review Act contained no provisions requiring a rent reduction or smaller increase when the quality of maintenance and services provided deteriorated. In the Residential Tenancies Act, however, sections 131(1)c and 132(1)s specifically instruct a commissioner to consider changes in the standard of maintenance and repair in a rent determination hearing. The position is, however, unclear at this time since another relevant section of the act, section 28, has yet to be proclaimed. Section 28(1)c would charge a landlord with the duty to provide and maintain all existing services and facilities (parking, elevators, intercoms, etc.). Any 'substantial' reduction in the provision of services and facilities is deemed a breach of this duty (s. 28(2)). When such a breach occurs, a tenant may apply to the commission. If mediation fails, a hearing is held and the commission may award remedies ranging from an order to the landlord to refrain from further breaches to termination of the tenancy (s. 28(4)). The landlord may also be ordered to 'compensate' the tenant for any loss that has been or will be suffered as a result of the breach. While it is clear that this compensation can take the form of a lump-sum payment to the tenant, it is not clear whether a reduction in future rents could be ordered in addition to or in place of a lump-sum payment.

APPEALS

Section 13 of the Rent Review Act permitted any party to appeal an RRO's order by notifying the other parties and filing a notice of appeal with the Rent Review Board within twenty-one days of the date of the order.

Pending the outcome of the appeal, execution of the RRO's order was stayed. While a party represented at the RRO's hearing could appeal as of right, a party who was unrepresented at that hearing had to receive permission to appeal at the beginning of the appeal hearing. Because RRO's were not required to keep records or transcripts of their proceedings, the appeal necessarily proceeded by way of a hearing de novo. The board could either affirm the RRO's order or replace with any other order an RRO was empowered to make.

The appeal procedure is much the same under the Residential Tenancies Act, sections 117-9. A party to a review application may appeal a commissioner's order by filing the appropriate notice with the commission within fifteen days of receiving the order and notifying any other parties. Again, a party not represented at the commissioner's hearing must obtain permission to appeal, in this case from a member of the Board of Commissioners. Parties may also be added to an appeal (if, for example, the rent under appeal was set in whole building review).

While the Rent Review Act required an appeal to be considered by means of a hearing de novo, the Residential Tenancies Act does not. The new act requires a commissioner to prepare reasons for his order and forward them to all parties to the appeal, who must then file statements setting out which findings they dispute; uncontested findings are deemed true. The appeal hearing is held before a panel composed of two appeal commissioners and a member of the board of commissioners, none of whom took part in the original hearing. The parties are limited to presenting evidence on the issues raised by their statements. The appeal panel, by majority, may either affirm the commissioner's order or replace it with any other order a commissioner is empowered to make. Unlike the Rent Review Act, the new act does not require that the appeal panel contain tenant representatives. However, it seems that former members of the Rent Review Board, including tenant representatives, have been made appeal commissioners.

Appendix B
The decontrol experiences of other jurisdictions

ALBERTA

Alberta's rent control program came into effect on December 13, 1975, when the Temporary Rent Regulation Measures Act received royal assent. The controls this legislation established were similar to those now in effect in Ontario. They applied only to units already rented in 1975. A landlord could obtain the guideline rent increase without application,[1] while increases in excess of the guideline had to be approved by a regulation officer on the basis of cost increases. A discontinuation-of-services provision protected the value of the tenancy.

The form of decontrol employed by Alberta was a combination of the blanket-lifting and rent-level methods. The Rent Decontrol Act, which came into force on July 1, 1977, limited rent increases only until June 30, 1980. However, any rental unit that reached the 'decontrol limit' prior to that date was freed from controls on January 1, 1978 or six months after the decontrol limit was reached, whichever was later. The act established the following decontrol limits: $375 per month for units of three or more bedrooms; $325 per month for two bedroom units; $275 per month for units of less than two bedrooms (Alberta 1977, s.7).

The theory behind the scheme was that higher-priced units should be deregulated at first, as their tenants could afford higher rents. Supposedly, vacancy rates for high rent units were also higher, so that rent

1 Guideline increases under the Alberta program were: 1976 - 10 per cent; 1977 - 9 per cent; 1978 - 8 per cent or $20 per month (whichever was greater); 1979 - 8 per cent or $20 per month (whichever was greater); 1980 - 8 per cent.

increases would in any event be moderated by market forces. Controls applied to low-rent units for a longer period, presumably because of their occupancy by low-income tenants (Edmonton Journal 1977).

Rents were expected to rise rapidly when all remaining controls were finally lifted in July, 1980. Despite an apparent boom in housing construction (CMHC 1979, 10), vacancy rates in Calgary and Edmonton were close to zero, and tenants were receiving notice of rent increases of 25 to 30 per cent (Globe and Mail 1980). The housing shortage was probably attributable to increased demand resulting from increased incomes, demographic changes, and immigration.

The most interesting feature of Alberta's decontrol system is its demonstration that the rent-level method need not result in pockets of substandard, controlled housing; it can be applied in conjunction with subsequent blanket decontrol. The Alberta experience also shows that the size of rent increases upon decontrol, by whatever method, depends upon conditions in the housing market. When there is considerable excess demand in the market for units with rents above the decontrol level, rent increases are likely to be large.

Alberta's decontrol package might run into problems if it were applied in Ontario, primarily because of political differences between the two provinces. If rent increases like those in Alberta were to occur in Ontario, popular opposition might force the reapplication of controls.

Another potential problem with applying Alberta's rent-level scheme to Ontario is that, because of higher rents, the Toronto housing market would probably become decontrolled more rapidly than housing markets in other parts of the province. A practical way around this problem would be to tie the rent level of each type of apartment in each city to the corresponding average rent.

SASKATCHEWAN

Rent control was introduced in Saskatchewan in 1976 by an amendment to the Residential Tenancies Act of 1973.[2] The office of the rentalsman was

2 Section 12 of An Act to Amend the Residential Tenancies Act (Saskatchewan 1976) created rent control by adding Section 34 to the Residential Tenancies Act of 1973.

established to administer the program. Controls applied to most residential premises within a five-mile radius of a city, town, village, or hamlet; approximately 80,000 rental units were affected (Saskatchewan 1976a). The form of control was generally similar to Ontario's.[3]

Section 3(4) of the legislation empowered the lieutenant governor in council to order that controls not apply to particular areas or classes of premises as of specified dates. This provision has been used to exempt new construction (that is, housing built after October 1, 1975) from all regulation. It has also been used to decontrol every jurisdiction in Saskatchewan except Regina and Saskatoon, and to place decontrolled premises under 'rent review'. Under rent review, a landlord may charge any rent, but a tenant may seek relief from the rentalsman when the increase is unjustified by cost increases.

The criterion used to decide where and when to decontrol was the vacancy rate as a measure of excess demand. In general, decontrol was applied first to small towns, then large towns, and finally small cities. Regina and Saskatoon remain under controls because of their persistently low vacancy rates. An estimated 17,000 to 18,000 units are subject to controls in each of the two major cities;[4] thus we conclude that some 44,000 units in the province have been decontrolled.

The mode of decontrol employed by Saskatchewan has not been very controversial. Since it basically involves decontrolling housing markets in which there is little or no excess demand, it is unlikely that rents have increased rapidly upon decontrol. Relatively few tenants have applied for review of 'unconscionable' increases. Controls remain, however, in Regina and Saskatoon, where low vacancy rates indicate the possible presence of considerable excess demand and consequently the potential for large rent increases if controls are lifted.

Saskatchewan has adopted a politically easy decontrol strategy. However, its long-run desirability is questionable. Controls are being

3 This statement requires some clarification. The landlord had to apply to the rentalsman for all rent increases. Increases in excess of the guidelines (1975 - 10 per cent; 1976 - 8 per cent; 1977 - 10 per cent) were granted when justified by cost increases. Since 1978, however, establishing 'fair' rents for controlled premises, rather than passing through cost increases, has been of primary concern.

4 Ken McKenzie, Rentalsman's Office, May 29, 1980: telephone interview.

retained in the province's two largest cities. It was argued earlier that when controls are effective, they lower vacancy rates and may create excess demand. Thus there is now no market mechanism to cause Regina's and Saskatoon's vacancy rates to rise so that their housing markets will be decontrolled. Therefore, the danger exists that rent control will become a permanent feature of these two cities.

MANITOBA

Manitoba's rent control program came into effect on May 15, 1976, when the Rent Stabilization Act was proclaimed. The act created a system of controls much like Ontario's. Rent increases were ordinarily restricted to guideline amounts,[5] but greater increases were granted to landlords who could satisfy a rent review officer that their costs had increased by more than the guideline allowed. An additional increase could be granted to landlords experiencing negative cash flows. The new construction exemption differed from Ontario's in that units in buildings completed after January 1, 1976 were exempt for only a five-year period.

The province's decontrol strategy is embodied in 1978 amendments to the Rent Stabilization Act. Residential rental premises outside Winnipeg and Brandon were decontrolled as of September 30, 1978. In Winnipeg and Brandon decontrol now applies to residential premises in three situations:

- when the unit is in a building for which the first occupancy permit was issued on or after October 1, 1973;
- when the unit rents for more than $400 per month;
- when the unit becomes vacant after September 30, 1978 and the tenant voluntarily (that is, in the absence of harassment) gives up possession or the landlord is granted an order for possession under Manitoba's Landlord and Tenant Act.

5 Guideline increases under the Manitoba program were: from July 1, 1975 - 10 per cent (retroactively); from October 1, 1976 - 8 per cent; from October 1, 1977 - 7 per cent; from October 1, 1978 - 6, 5.5, or 5 per cent, depending on whether landlord paid for both heat and power, either, or neither; from October 1, 1979 - 5, 4.5, or 4 per cent, depending on whether landlord paid both heat and power, either, or neither.

In each case, the landlord must apply to the Rent Stabilization Board for an exemption order. The amendments empowered the lieutenant governor in council to set a termination date for all controls not be earlier than June 30, 1980, but as yet not date has been set.

In September 1978, approximately 120,000 rental units in Manitoba were subject to controls; the Winnipeg Tribune (1978) estimated that 20,000 of them outside Winnipeg and Brandon were decontrolled at that time. The Manitoba Ministry of Consumer and Corporate Affairs and Environment estimated that 7000 rental units in Winnipeg and Brandon had been issued occupancy permits on or after October 1, 1973 and were therefore eligible for decontrol; by December 31, 1979, 4000 of these units had been issued exemption permits. By December 1980, approximately 400 units renting for more than $400 per month had been decontrolled. No figures are available for the number of units decontrolled by becoming vacant, but the extent of vacancy decontrol may be inferred from an October 1978 survey indicating that the annual rate of tenant turnover is on the order of 15 per cent.[6]

Like Saskatchewan, Manitoba first decontrolled premises in slack housing markets outside the major cities. In Winnipeg and Brandon, it has adopted a mixed form of vacancy and rent-level decontrol, and it has granted new construction a permanent, rather than temporary, exemption in order to stimulate construction and reduce the tightness of their housing markets. Controls are retained for most urban premises because low vacancy rates are seen as a warning that large rent increases would occur if they were removed. Eventually, however, the present measures will completely decontrol Brandon's and Winnipeg's rental housing markets. In the interim, they will suffer the problems associated with vacancy decontrol - substantially reduced tenant mobility in the controlled sector, and inequities between long-time residents and new arrivals.

UNITED STATES: POSTWAR DECONTROL

In the United States, the Emergency Price Control Act of 1942 froze rents as part of a general wartime wage and price freeze. In 1946, all controls

6 J.E. Mason, Deputy Minister of Consumer and Corporate Affairs and the Environment: private communication, June 25, 1980.

save rent control were dropped. Local jurisdictions were permitted to end rent control in 1949, bringing an expectation of substantial rent increases: rents had increased only 14.5 per cent over the 1946 level (some increases had been permitted), while prices generally had increased 32.4 per cent (The Fraser Institute 1975, 194-5).

The United States Department of Labor conducted rent surveys in a number of cities before and after decontrol. Walker (1975) presents some of the results, which are reproduced in Table B.1. While there are severe problems in interpreting the data, which we have been unable to resolve,[7] it is clear that the effects of decontrol varied markedly from city to city and that some cities encountered sizable rent increases upon decontrol.

Other evidence suggests that the rise in rents slowed down after the initial impact of decontrol. Grebler (1952) presents rent indexes for ten cities freed of controls for different lengths of time. These data are produced in Table B.2. The average monthly increase (because the periods of decontrol vary, this is more significant than the total percentage increase since decontrol) ranges between 0.6 per cent and 2.6 per cent, with smaller increases in cities whose rents have been decontrolled longer.

The American experience shows that rent increases upon decontrol depend on conditions in the housing market. When there is considerable excess demand, rents increase greatly. Once the adjustment to free markets rents is made, the rate of increase decreases, and rents for some units may actually decrease. However, the American experience is probably irrelevant to any discussion of decontrol in Ontario, as the degree

7 The appropriate interpretation of these data has been the subject of some debate; see, for example, Watson (1977) and Watson and Walker (1978). One difficulty is that it is not clear what the data labelled 'average percentage increase in the general rent level of units whose rents are free to rise' actually represent. In any event, if one multiplies the 'percent of all units having increases' by 'their average percentage increase', one does not get the figures in the third column of Table B.1, but higher ones. Take Houston for example: .31 x .413 = .12803 - that is, a 12.8 per cent increase in the Houston 'rent level', while the table indicates 10.7 per cent. One could get the latter figure only if there had been an average decrease of 3 per cent in the rents of the remaining 69 per cent of units, those whose 'rents are free to rise'. Moreover, the average increases in the general rent level is not an annual rate but only an average over the survey period, unless it can be assumed that each unit has had but one rent increase per year.

TABLE B.1

Increases in rents free to rise after termination of federal rent control in cities: all rent ranges

	Percentage of all units having increases	Average percentage of increases	Average percentage increase in general rent level[a]	Survey dates	Date of decontrol
Houston, Texas	31	41.3	10.7	8/15/49-11/15/49	10/19
Beverly Hills, Calif.	74	41.0	26.7	10/15/49-3/1/50	12/7
Dallas, Texas	67	35.4	20.5	4/15/49-11/15/49	6/23
Topeka, Kansas	40	30.3	10.5	7/15/49-11/15/49	9/14
Eugene, Oregon	38	30.3	9.4	6/15/49-2/15/50	8/18
Knoxville, Tennessee	61	26.8	15.8	5/15/49-11/15/49	6/14
Jacksonville, Fla.	56	26.2	12.3	6/15/49-11/15/49	8/5
Oklahoma City, Okla.[b]	17	26.2	2.9	9/15/49-1/15/50	11/23
Omaha, Nebraska	62	21.9	14.2	9/15/49-1/15/50	11/2
Milwaukee, Wisc.[c,d]	60	20.2	12.2	5/15/49-2/15/50	8/5
Spokane, Washington	46	18.6	8.2	5/15/49-11/15/49	7/25
Witchita, Kansas	35	18.1	6.4	10/15/49-3/1/50	12/29
Salt Lake City, Utah	46	16.2	7.1	6/15/49-11/15/49	8/5
Madison, Wisc.[d]	51	12.3	5.9	6/15/49-2/15/50	8/5

NOTES: Data excludes units having continuous leases and units individually decontrolled before area-wide decontrol.

a General rent increase of 20 per cent granted prior to decontrol.

b Includes all units - data on rent free to rise not available.

c State controls were substituted for federal controls.

d Includes rent which did not increase.

SOURCE: U.S. Senate (1950, 462); reprinted in Knight (1962) Walker and (1975, 194)

Appendix B

TABLE B.2

Percentage increases in rent indexes after decontrol for ten U.S. cities

	Date of rent decontrol	Percentage increase since decontrol	Number of months since decontrol[a]	Average percentage increase per month
Birmingham	May 1950	37	15	2.5
Houston	Oct. 1949	36	22	1.6
Jacksonville	Aug. 1949	15	24	0.6
Los Angeles	Dec. 1950	21	9	2.3
Milwaukee	Aug. 1949[c]	39	24	1.6
Mobile[b]	May 1950	14	15	1.0
Norfolk[b]	Mar. 1950	30	16	1.9
Portland, Ore.	Dec. 1950	16	9	1.8
Richmond[b]	June 1950	31	12	2.6
Savannah[b]	Mar. 1950	38	16	2.4

NOTES:

a Approximate number of months to latest index date.
b Recontrolled shortly thereafter; however, rents during the third quarter of 1951 still reflected an uncontrolled rental market.
c Date of removal of federal rent control. Until August 1950 rents were much more loosely controlled under state laws and increased 17 per cent within twelve months.

SOURCE: U.S. Bureau of Labor Statistics; reprinted in Grebler (1952, 481)

of excess demand present in the immediate postwar housing market in the United States is unlikely to arise in present-day Ontario.

HONG KONG

Rents in Hong Kong have been controlled in response to chronic housing shortages caused, in part, by periodic influxes of refugees from China. As in New York City, there is a two-tiered system of controls.[8]

8 This discussion draws heavily on the work of O'Brien (1977a, 1977b) and Bradbrook (1977).
Part II controls, which apply to postwar domestic premises, are of little interest to us here. At the outset of a new tenancy, rent may increase by any amount agreed upon by landlord and tenant. If no agreement is reached, the landlord must apply to the Department of

Part I of the Landlord and Tenant (Consolidation) Ordinance constitutes the present rent control law and applies to only the comparatively few remaining prewar premises.[9] The ordinance grants tenants security of tenure.[10] Rents were initially frozen at the December 29, 1941 level, increased 30 per cent in 1947, 25 per cent in 1953, and 50 per cent in both 1975 and 1976. A landlord who spends more than HK $5000 on additions and improvements is permitted a permanent annual increase in rent equal to 20 per cent of the cost of these additions and improvements. Nonetheless, controlled rents in 1977 were some 300 to 400 per cent below free market levels (Bradbrook 1977, 330).

Part I premises can be decontrolled by order of the governor in council upon the recommendation of a tenancy tribunal. Redevelopment has been the usual ground for such orders (Bradbrook 1977, 325).

Other, more innovative measures have been taken to get Part I premises decontrolled. Since 1968, landlords and tenants have been permitted to make agreements under which the tenant is compensated for surrendering his tenancy (O'Brien 1977b, 38). Originally, the premises remained subject to control, but a 1973 amendment to the Landlord and Tenant (Consolidation) Ordinance provides that an agreement to terminate excludes the premises from further application of controls. The agreement must be approved by the commissioner of rating and valuation, who ensures that the tenant gets a 'fair' deal.

The Landlord and Tenant (Consolidation) Ordinance also provides that a landlord and tenant may apply to a tenancy tribunal for permission to enter into a tenancy agreement, for a term not exceeding five years, at a rent in excess of the controlled rent. A 1975 amendment has the effect of permanently excluding from controls any premises for which such an application is approved. In theory, the provision gives the tenant, who has

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Ratings and Valuation, which determines the permissible increase as the lesser of 21 per cent or fair market rent less current rent divided by four. This factor was reduced to four from five in 1975.

9 O'Brien (1977b) estimates that 9768 prewar buildings existed in 1970, with only 4191 remaining in 1976. Thus over the six-year period, the number of prewar buildings declined nearly 14 per cent annually.

10 The removal of a protected tenant is extremely difficult. '[The] legislation [has] made the removal of tenants an epic comparable to the trials of Odysseus trying to return to Troy [sic] - once in possession, it required persistence, ingenuity, and at times doubtful practices to get them evicted by court order.' O'Brien (1977b, 10).

security of tenure, additional bargaining power to negotiate with the landlord for repairs and improved services (Watson 1977). There is no evidence available concerning such bargains between landlords and existing tenants, but in the few cases in which premises have become vacant in the absence of an agreement to surrender and hence are still subject to controls, it seems that landlords have insisted upon prospective tenants agreeing to apply to remove the premises from controls (Bradbrook 1977, 331).

Both the 'agreement to surrender' and 'agreement to exempt' methods of decontrol have their attractions. The former encourages mobility - yet it also gives a tenant an incentive to appear reluctant to move. The latter should lead to improved maintenance and reverse the trend of control-induced deterioration. However, both methods require scrutiny of all agreements by some form of administrative agency. Otherwise a landlord might harass a tenant in order to secure an 'agreement' to surrender or deny him some of the benefits of making an agreement to exempt (for example, by harrassing him into leaving before the agreement expires). Such monitoring may be practical in a geographically small area such as Hong Kong, but it would be impractical in Ontario.

CONCLUDING COMMENTS

It should be apparent that there is little hard empirical evidence on the decontrol experience in other jurisdictions. However, some observations may be made. First, the size of rent increases upon full decontrol is determined by conditions in the housing market. If there is excess demand at the controlled rents, as in Alberta, large increases will follow decontrol. Conversely, where there is little or no excess demand, as in Manitoba outside Brandon and Winnipeg, rent increases will be moderate. Second, the rate of decontrol depends upon the method chosen. Blanket-lifting permits rents to rise at the conclusion of existing tenancy agreements, usually within a year. Vacancy decontrol proceeds more slowly, probably at a rate below the turnover rate in the uncontrolled market. The rapidity of decontrol by the rent-level method depends on the level chosen and the distribution of controlled rents. One cannot say a priori whether rent-level decontrol proceeds more or less rapidly than vacancy decontrol.

In summary, while rents upon complete decontrol are determined by conditions in the housing market, government policy can affect, directly or indirectly, the path of rents to their free-market levels. A government using the rent-level method can reduce the size of rent increases that occur upon decontrol by allowing controlled rents to rise to the specified level at a rate faster than the rate of increase in uncontrolled rent. Similarly, if vacancy decontrol is employed, controlled rents can be permitted to rise more rapidly than uncontrolled rents to reduce the difference between the controlled and free market rents when the unit becomes vacant. The size of rent increases upon decontrol can also be reduced by increasing the supply of housing through direct subsidies to developers and other incentives.

Appendix C
The rent control and decontrol experience in New York City

This discussion will proceed on an historical basis, starting with the introduction of rent control in New York City in 1943. The history is somewhat labyrinthine, and it may help the reader to consult Table C.1, which sets out the chronology of New York's rent regulation, and Table C.2, which gives the control status of rental units from 1965 to 1978.

RENT CONTROL IN NEW YORK CITY

Rent control came into effect in New York City, on November 1, 1943, as part of the wartime system of price controls created by the Federal Emergency Price Control Act of 1942.[1] Rents for all rental housing were frozen at the level charged on March 1, 1943. Tenants were provided with security of tenure and landlords' power to raise rents was limited (CJLSP 1967, 33). Federal controls continued in New York City until 1949, when New York State enacted its own rent control legislation. The state's law froze rents at the levels previously set by federal law but authorized rent increases for landlords who could show economic hardship (CJLSP 1967, 35). The legislation was amended in 1951 to allow a return of 4 per cent of the assessed value of the property; this allowance was raised to 6 per cent in 1953, when landlords were also given a 15 per cent across-the-board increase in rents. In 1962, the state ordered cities with populations greater than one million either to take over rent control or to abolish it (CJLSP 1967, 35). Consequently, New York City enacted its own rent control law, freezing rents at the maximum permitted by the state law. Rent control applied to all buildings built before February 1, 1947 except

1 This discussion draws heavily on Columbia Journal of Law and Social Problems (1967).

TABLE C.1

A chronology of rent regulation in New York City

1943	Rent control starts under Federal Emergency Price Control Act of 1942.
1949	Federal controls replaced by New York State controls.
1962	New York State controls replaced by New York City controls.
1969	Rent Stabilization Law (RSL) introduced.
1970	Maximum Base Rent (MBR) program introduced.
1971	New York State introduces compulsory vacancy decontrol.
1974	Emergency Tenant Protection Act (ETPA) ends vacancy decontrol in New York State.

one- and two-family dwellings and buildings that had been substantially reconstructed before May 1, 1962.

To obtain a rent increase under the city's law, a landlord had to certify that the building was 'violation free' and that he was maintaining and would continue to maintain all essential services. Neither requirement was a mere formality. Landlords complained that the cost of satisfying these preconditions made it cheaper in many cases not to seek a rent increase. They also accused tenants of deliberately creating code violations to forestall rent increases (CJLSP 1967, 40).

Before 1970, the principal grounds for rent increases under the city's law were:

- Hardship. Increases were granted to landlords able to demonstrate that their net annual return - gross revenue less operating expenses and a 2 per cent depreciation allowance (or the amount shown on the latest federal tax return) - was less than 6 per cent of the building's valuation - its unequalized assessment value[2] or its bona fide sale price. But the

2 Equalized assessed values are used by the New York State Board of Equalization and Assessment to resolve inequalities caused by different methods of assessment used by different localities. In essence, equalized assessed value is the price the board estimates a willing buyer would pay a willing seller in a normal market.

Appendix C

TABLE C.2

Control status of renter-occupied units, New York City
(in thousands)

Control status	1960	1965	1968	1970	1975	1978
Total	2078 (100%)	2077 (100%)	2096 (100%)	2167 (100%)	1999 (100%)	1930 (100%)
Controlled[a]	1476 (71.0%)	1336 (64.3%)	1267 (60.4%)	1265 (58.4%)	642 (32.1%)	402 (20.8%)
Decontrolled[b]	163 (7.8%)	187 (9%)	220 (10.5%)	158 (7.3%)	251 (12.6%)	268 (13.7%)
Stabilized[c] pre-1947	----	----	----	----	467 (23.4%)	552 (28.6%)
Stabilized[c] 1947 and later	----	----	----	350 (16.1%)	303 (15.2%)	320 (16.6%)
Never regulated, publicly aided	199 (9.6%)	318 (15.3%)	392 (10.7%)	109 (5.1%)	153 (7.6%)	198 (10.3%)
1 or 2 rooms lacking specified facilities	129 (6.2%)	98 (4.7%)	74 (3.5%)	63 (2.9%)	18 (0.9%)	25 (1.3%)
Public housing	111 (5.3%)	137 (6.6%)	144 (6.9%)	156 (7.2%)	165 (8.2%)	165 (8.5%)

NOTES:

a Units subject to the provisions of the Rent Control Law and Regulations (i.e., private rental units in existence before February 1, 1947 that have not been decontrolled).

b Rental units previously subject to rent control that have been removed from controls.

c Rental units exclusively in structures of six or more units eligible to join the RSA. The pre-1947 group includes rental units that were formerly controlled but that have since been decontrolled under vacancy decontrol and placed under rent stabilization by ETPA, or that have become vacant and been placed under stabilization by ETPA; the later group includes stabilized rental units (i.e., those constructed 1947-69) that have not been destabilized or that were destablized under vacancy decontrol but restored to stabilized status by ETPA.

SOURCE: Marcuse (1979, 227)

landlords who stood most in need of this provision were seldom able to meet the requirement that their buildings be violation-free.

- Lease Renewal. The law provided for a voluntary 15 per cent increase from tenants every two years. But, as the tenant had security of tenure, could not be evicted, and, therefore, invariably refused to agree to an increase, this provision in practice only generated a rent increase when an apartment changed hands.

- Capital improvements. Landlords were permitted permanent rent increases related to the estimated useful lives of building-wide or single-unit improvements. Decreases in rent were required if services were diminished or the building was in violation of codes. Intended to force landlords to maintain their buildings, these rent decreases often led to abandonment.

Rent stabilization

In 1969, only dwelling units constructed prior to February 1, 1947 were subject to rent control. In the uncontrolled sector, inflation and low vacancy rates had resulted in rapidly increasing rents. As a result, the city passed the Rent Stabilization Law (RSL) of 1969, which was intended to moderate rent increases and ensure that tenants retained their apartments (Brooklyn Law Review 1970, 306-7). Rent stabilization originally applied to most residential dwelling units in buildings of six or more units that were not already subject to standard rent control - that is, to buildings constructed after February 1, 1947 and to decontrolled dwelling units formerly subject to city or state rent control laws. New construction (buildings for which a certificate of occupancy was granted after March 10, 1969) was exempt.

Rent stabilization is administered through a tripartite structure: the Rent Stabilization Association (RSA), the Conciliation and Appeals Board (CAB), and the Rent Guidance Board (RGB). The RSA is made up of owners of apartments subject to the law. It is responsible for administering a code regulating the conduct of its members and for collecting sufficient dues to defray the costs of administering and enforcing the law. (Standard rent control is imposed upon buildings whose owners fail to join the RSA or refuse to comply with the RSL.) The CAB is a nine-member

board comprising an impartial chairman, four representatives of the public, and four representatives of owners. It decides hardship cases brought before it by landlords and complaints brought by tenants. It tries conciliation and then, if necessary, holds a hearing and makes an order binding on the parties to the dispute. The RGB is required to determine fair rent increases. Each year it establishes limits for rent increases on the basis of increases in costs, as measured by the U.S. Department of Labor.

In 1969, rents for stabilized apartments were rolled back to the rent charged in May 31, 1968 plus the increase allowed by the guideines. To protect the value of the tenancy, a landlord was required to provide all services furnished on May 31, 1968, even if he did not charge the guideline maximum (Brooklyn Law Review 1970, 310). Initially, a 10 per cent increase was permitted for one- and two-year renewal leases and a 15 per cent increase for a three-year renewal lease; lower increases were permitted for two- and three-year vacancy leases. In either case, the tenant could select the lease's term. Since then, guideline increases have sometimes been higher for vacancy leases than for renewal leases. However, the tenant's right to renew is safeguarded: if a landlord harasses a tenant in order to obtain a vacancy and secure the higher rent on a vacancy lease, his membership in the RSA may be terminated, subjecting him to standard rent control. Table C.3 sets out the guideline increases for the period 1968-79.

A landlord participating in the rent stabilization program may obtain additional rent increases if he:

- provides new services or equipment within an apartment;
- makes a building-wide capital improvement (a CAB order is required for this increase);
- establishes that his average net income over the most rent three-year period was less than the average net income earned from the building between 1968 and 1970 (again, a CAB order is required). Before July 1, 1975 this type of increase was granted if the owner failed to maintain the profit rate he had had during the preceding five-year period.

THE MAXIMUM BASE RENT PROGRAM

The Maximum Base Rent (MBR) program, introduced in 1970, represents a

TABLE C.3

Standard guideline allowances, 1968-79

Leases commencing	1-year renewal lease	2-year renewal lease	3-year renewal lease	Vacancy lease
6/1/68-6/30/70	10.0%	10.0%	15.0%	{ 5.0%[a] 10.0%[b]
7/1/71-6/30/71	6.0%	8.0%	11.0%	7.5%
7/1/72-6/30/72	7.0%	9.0%	12.0%	c
7/1/72-6/30/73	6.0%	8.0%	10.0%	c
7/1/73-6/30/74	6.5%	8.5%	10.5%	c
7/1/74-6/30/75[d]	8.5%	10.5%	12.0%	---
7/1/75-6/30/76[d]	7.5%	9.5%	12.5%	5.0%
7/1/76-6/30/77[d]	6.5%	8.0%	11.0%	5.0%
7/1/77-6/30/78	6.5%	8.5%	11.5%	5.0%
7/1/78-6/30/79	3.5%	5.5%	7.5%	5.0%

NOTES:

a For a two-year lease
b For a three-year lease
c Vacancy destablization was in effect between 7/1/71 and 6/30/74.
d For some apartments that had previously been vacancy decontrolled or destabilized, the standard guidelines allowances from July 1974 through June 1977 were subject to a further guideline limitation formula.

SOURCE: New York City (1978, 22-3)

liberalization, but nevertheless a continuation, of rent control in New York City. Each rent-controlled unit is assigned a 'computer-calulated' rent (the maximum base rent, MBR),[3] and its rent may be increased to this

3 Because of administrative difficulties, MBRs are no longer literally 'computer-calculated'. Rather, a city official computes MBRs using a calculator.

level at a controlled rate. Because the lower of either the free market rent or MBR is the binding constraint on the rent charged,[4] the MBR program is in one sense a decontrol measure. When the maximum base rent for a unit exceeds its free market rent, it is effectively decontrolled.

Local Law 30, which created the MBR system, was passed by city council in mid-1970 in response to disturbing trends in New York's housing market.[5] Comparison of housing field-surveys for the periods 1960-4 and 1965-7 showed that unrecorded losses (that is, units withdrawn from residential use, excluding those actually demolished or structurally merged with other units) had increased from 15,000 units per year to 38,000 units per year, while foreclosures for nonpayment of taxes had doubled. The inventories of officially 'dilapidated' and 'deteriorating' housing increased by 37 per cent and 44 per cent respectively; in 1967, some 400,000 occupied rental units were in these categories. According to the 1968 census, more than 365,000 of these substandard housing units were rent controlled.

Landlords attributed these trends to cost increases in excess of the rent increases permitted by controls. In the face of this, they were taking measures that ranged from cutting back expenditures in order to maintain the existing cash flow to 'walking away' from the building, 'first by ceasing to pay real estate taxes or to keep the building in repair and finally by ceasing to collect rents or render essential services' (Kristof 1976, 11). City legislators accepted the landlords' position that there was a difference between being unwilling to carry out proper maintenance and being financially unable to do so. Hence the object of MBR was, and continues to be, the improvement of maintenance by increase landlords' revenues.

At the core of the MBR system is a cost-plus-profit formula for establishing maximum base rents for every rent-controlled unit. The maximum gross building rental (MGBR) for a building with no commercial income is given by

4 This statement requires qualification. If the rent collected when the program began was in excess of MBR, the rent was frozen at this level until MBR caught up with it. This rent is termed the maximum collectible rent (MCR).

5 Summarized in Hsai (1974, 118-9).

$$MGBR = RET + O\&M + W\&S + V\&C + RCV,$$

where RET is real estate taxes (about 15 per cent of MGBR); O&M is operating and maintenance allowance (about 39 per cent); W&S is water and sewage (about 2 per cent); V&C is vacancy and collection allowance (about 1 per cent); and RCV is return on capital value (about 43 per cent) (New York City 1977, s.24).

The annual return on capital value, which makes up some 43 per cent of MGBR, is fixed at 8.5 per cent of equalized assessed value.[6] This amounts to approximately 15 per cent of unequalized assessed value, compared to the minimum 6 per cent return on unequalized assessed value that owners were entitled to under rent control.

The allowance for operating and maintenance expenses depends on the age of the building, the number of rooms in the building, and the number of units in the building. For a 'normal payroll' building (one in which the annual expenses for labour, including wages and fringe benefits, for all employees engaged in its operation, maintenance, and service does not exceed $300 per rental unit),

$$O\&M = N(\$265.54 + \$0.36N + \$73.32R + \$2.15A),$$

where N is the number of units in the building, R is the average number of rooms per unit, and A is an age factor (New York City, s.24).

In order to apportion MGBR to individual units, each unit is assigned a room index (RF) based on the number of rooms in the unit (that is, a one-room unit is assigned an index of 75, a two-room unit is assigned 100, and so on) and adjusted for floor level. If the building is a walk-up, 2 per cent is added to the RF for each floor below the middle floor, and 2 per cent subtracted for each floor above it. In a building with an elevator, the desirability relationship is reversed, with 1 per cent differentials in RF (New York City, s.24). Thus the maximum base rent of a unit in a building with no commercial income is given by

$$MBR = \frac{RF}{\Sigma RF} MGBR.$$

6 See note 2.

Appendix C

Maximum base rents remain in effect for at least two years; provision is made for biennial adjustment of MGBR to reflect changes in any of its components. Provision is also made for adjustment of the O&M allowance in light of actual operating and maintenance expenses reported by landlords at the request of the Housing and Development Administration (New York City, s.25).

The MBR formula is the core of the MBR system. However, the New York State Study Commission for New York City (known as the Scott Commission) questioned the ability of the MBR formula to determine individual 'fair' rents (for example, although the room index is adjusted for floor location, no account is taken of other factors, such as the size of rooms) and the likelihood that the O&M allowance would provide sufficient funds for operation and maintenance of rent-controlled buildings.

The O&M formula was derived from a series of multiple regressions. Two data sets were available: that collected by George Sternlieb in preparing his The Urban Housing Dilemma (1976), and a 'statistically significant' sample of 391 buildings for which applications for hardship increases had been made. As Sternlieb's data generated results having low statistical significance, the second set was used (New York State 1972, 62). However, this choice has been criticized for several reasons. First, while the O&M formula was to apply to all buildings, the data set did not contain an accurate proportion of small and older buildings, presumably because their owners had always found the paperwork necessary for securing hardship increases too complex and too costly. Second, in order to get a suitable coefficient of variation, it was necessary to make an artificial distinction between high and normal payroll buildings. Yet payroll costs may merely be indicators of the presence of other independent variables, which, if taken into account, might produce a more equitable and accurate formula. Finally, the same data set was used to predict that about 14,000 error correction notices would be needed because of landlords' supplying incomplete data for determining maximum base rents; in fact, some 500,000 notices were issued. Since the hardship application sample proved so unrepresentative in the error correction process, it may also have generated an inaccurate O&M forumla.

The implementation of the MBR system was beset with problems. The program provided for an interim rent increase for the period August 1, 1970 to December 31, 1971; landlords were required to certify that 90 per

cent of the increase was used for operations and maintenance. The amount of the increase depended upon the number and amount of past increases for a particular unit. For example, housing that rented for less than $60 per month received $10 and $15 per month increases for units of less than four and four or more rooms respectively. Units that had received total increases of 15 to 30 per cent since May 1, 1953 were granted a further 8 per cent.

Despite thirty years of rent control, very little of the information needed to compute MBRs had been collected or filed by 1970. Thus in order to collect the interim increase, landlords had to file forms for each building and each rental unit, setting out:

- the assessed value in the previous year;
- water and sewage costs in the previous year;
- net commercial income;
- the number of controlled and decontrolled rooms in the building;
- the number of apartments in the building; and
- the number of rooms in, and floor level of, each apartment in the building (Hsai 1974, 26).

However, the information actually supplied proved insufficient; the forms were poorly designed, and landlords, especially smaller one, found them too complex or lacked the resources and records to complete them. As a result, the number of error corrections reached 500,000 by August 1972 versus the predicted total of 14,000. Moreover, because of administrative delay, some 400,000 units had not received MBR orders by 1972.

As the MBR program is intended to upgrade the housing stock by closing the cost-rent gap, proper maintenance is the (nominal) prerequisite of MBR increases. Landlords receiving the 1971 interim rent increase had to certify that 90 per cent of it was directed to operation and maintenance of the building. Yet no inspections or audits were carried out, and there do not appear to have been any cases in which the interim rent increases were withdrawn because of false certifications. For subsequent annual MBR increases, the landlord has been required to certify two things:

- That he has corrected 100 per cent of rent-imparing violations and 80 per cent of other housing code violations on record on January 1 of the

preceding year (the burden is on tenants to secure a housing inspection prior to January 1 to have violations put on record).

- That he is maintaining and will continue to maintain all essential services.

The Scott Commission reported that some 200,000 units were denied MBR increases in 1972 because spot inspections revealed false certifications of violation removal. No other penalty was imposed. The certification of essential services is largely pro forma, as no inspection is carried out.

In practice, many landlords have not yet received full MBR. To prevent the sudden large rent increases that would have resulted if tenants had been obliged to pay full MBR immediately, rent increases have been limited to 7.5 per cent annually. However, as the MBR itself is constantly changing, it may in many cases never be attained. However, the MBR law also provided that if rental accommodation was vacant on January 1, 1972 or became vacant thereafter by voluntary surrender of possession by the tenant, the maximum base rent could be collected from the new tenant. Thus, upon vacancy, rents for some apartments can rise more than 100 per cent.

The United States Bureau of the Census has compiled longitudinally matched housing data for New York City. (The use of matched data ensures that changes resulting from the comparison of different units with each other over time are avoided.) For units that had been controlled in 1975 and were still controlled in 1978, the median gross rent of matched units increased from $136 in 1975 to $165 in 1978 (a 21.3 per cent increase). For unmatched units, rents increased 22.9 per cent (Marcuse 1979, 257). On the other hand, costs increased more slowly; the O&M cost index rose 17.1 per cent and the index of all taxes rose 13.9 per cent over the same period (Marcuse 1979, 204).

VACANCY-RATE DECONTROL

State and city legislators have always viewed the successive extensions of rent control in New York City as temporary measures. Since 1950, rent control legislation has provided for the mandatory decontrol of 'all or any particular class of housing accommodation' for which the vacancy rate exceeds 5 per cent (CJLSP 1967, 61).

The principal difficulty with using the vacancy rate as measure of a housing shortage warranting the continuation of rent control is that it ignores the relationship between the supply of and demand for rental housing. A basic proposition of economics is that if the price of a commodity is below the market clearing price, the quantity of the commodity demanded will exceed the quantity supplied at that price. The rental housing market is not exempt from this proposition. The median gross rents of controlled apartments in New York are well below those of similar uncontrolled apartments (that is, below the market clearing price), and a persistently low vacancy rate indicates excess demand for all units - caused in the uncontrolled sector by a spillover from the controlled sector.[7]

It is not surprising that no orders have been made pursuant to the mandatory decontrol provisions, except with respect to a few high-rent apartment categories. In 1964, apartments renting for $250 a month ($300 if furnished) on April 1, 1960 were decontrolled unless the tenant in occupancy on March 26, 1964 had children in secondary school or more than four relatives residing with him (CJLSP 1967, 61). The New York Times (date unknown) estimated that some 5000 units were decontrolled pursuant to this order, a figure Sternlieb (1976, 633) terms 'small'. In 1968, apartments renting for $250 a month ($300 if furnished) on April 1, 1965 were decontrolled unless the household of the tenant in occupancy on January 29, 1968 included four or more related persons.

VACANCY DECONTROL

In 1971, massive lobbying by the state Housing Commission and the real estate industry resulted in the passage of a bill providing for vacancy decontrol in New York State (Bales 1972). Apartments becoming vacant after June 30, 1971 were freed from all rent regulation (controls or stabilization) and could be rented at prices determined by landlord and tenant.

7 Net rental vacancy rates for New York City were 1.8 per cent in 1960, 3.19 per cent in 1965, 1.23 per cent in 1968, 1.5 per cent (estimated) in 1970, 2.77 per cent in 1975, and 2.95 per cent in 1978. Some difficulty regarding the comparability of these figures exists (Marcuse 1979, 101).

Appendix C

The principal advantage of vacancy decontrol is that initial large rent increases occur only when a new tenant arrives and the old tenant departs. Thus the impact of decontrol is felt only by households moving into the city, by households formed for the first time, and by those who find it necessary or convenient to move. These groups are supposedly able and willing to pay the going rent. A second advantage of vacancy decontrol is its administrative simplicity. All that is necessary is some form of supervision to ensure that landlords do not harass tenants of controlled apartments in order to secure vacancies. Financial simplicity is a third advantage, since vacated apartments are brought to their market rent (which may be higher or lower than the controlled or stabilized rent) in a single step.

The main disadvantage of vacancy decontrol is that it results in dissimilar rents for similar apartments. Apartments whose tenants stay for only a short period after decontrol reach free market rents rapidly; apartments occupied by tenants reluctant to move can remain at the controlled rent indefinitely. The 1970 census showed that approximately 300,000 renter households in New York City - one-quarter of all households in controlled units - had occupied their apartments since 1949 (quoted in Kristof [n.d.]b, 16). Vacancy decontrol gives landlords a substantial incentive to drive such tenants out. Thus the state law provided that exemption from further rent regulation would not apply to a unit whose landlord had harassed the tenant in order to secure a vacancy.

Unlike the earlier legislation transferring rent control from state to city administration, the vacancy decontrol legislation provided no mechanism for compiling a detailed record of the effects of decontrol on the city's rental housing market (Kristof [n.d.]a, 1). Unfortunately, there is little agreement between the rather limited empirical studies that have been conducted. The Temporary State Commission on Living Costs and the Economy of the State of New York (hereafter called the Temporary Commission) estimated that vacancy decontrol would potentially affect some 1,653,000 rent-controlled units and some 350,000 rent-stabilized units in the city (New York State 1974, 3). Decontrol turnover from mid-1971 to the end of 1973 was estimated at 0.83 per cent per month in the rent controlled sector and 0.89 per cent per month in the rent-stabilized sector (New York State 1974, 3). These figures imply that a total of 413,000

rent-controlled units were decontrolled and 82,000 stabilized units destabilized by the end of 1973. This represents some 25 per cent of the housing stock regulated in 1971. A second study of vacancy decontrol, based on data collected by the Community Housing Improvement Program, Inc. (CHIP), an owners' association, was undertaken by Frank Kristof. Survey forms were distributed to owners of approximately 40,000 rent-controlled buildings in New York City; 806 usable forms were returned. While this is not a statistically significant random sample, the survey has been widely used by CHIP and by the city (Kristof [n.d.]b, appendix). Of the 37,224 apartments in Kristof's sample, 7,348 or 19.7 per cent were decontrolled between July 1971 and December 1973; projecting these results city-wide, Kristof ([n.d.]b, 2-3) estimates that 'somewhere between 250,000-300,000 apartments have been decontrolled between July 1, 1971 and December 1973'. The Temporary Commission's somewhat higher estimate is probably too high, as its estimate of some 1,653,000 rent-controlled units in 1971 is well in excess of the 1,265,000 estimate for 1970 found in Table C.2. Applying the 0.83 per cent monthly turnover rate to the latter figure gives a total of only 280,000 units decontrolled between July 1971 and December 1973. In either case, it would seem that vacancy decontrol in New York City proceeded quite slowly, deregulating approximately 20 to 25 per cent of the rent-controlled inventory in thirty months.

Determining the size of rent increases attributable to vacancy decontrol is difficult because decontrol is an ongoing process. At a given point in time, the rent on a decontrolled apartment depends on rent increases prior to decontrol (for example, under MBR), the initial increase upon decontrol, and increases subsequent to decontrol. In a letter to the New York Times, the city rent commissioner claimed that 'vacancy decontrol has wreaked even more havoc on this city than we feared. Rentals have skyrocketed 102% in Queens; 97% in Brooklyn; 85% in the Bronx; and 75% in Manhattan' (quoted in Kristof [n.d.]a, 1). However, other studies gave a much lower estimate of rent increases attributable to decontrol. The Temporary Commission presented the results of survey of controlled buildings, conducted in 1973 by the city's Housing and Development Administration, that showed a city-wide increase in average monthly room-rent increase upon decontrol of 52 per. cent in 1972. Kristof's study ([n.d.]b) showed that average (mean) apartment rents went from $110 to

$155 (a 41 per cent increase) upon decontrol.[8] After initial decontrol, rents of these apartments increased to an average of $160 by the end of 1973. Kristof ([n.d.]b, 3) notes that the increase to full MBR permitted by the MBR system upon an apartment becoming vacant would have brought rents to an average of $141 per month. The $19 difference between vacancy-decontrolled and MBR-permitted rents is a rough measure of the difference between market and MBR rents.

New York State legislators intended that vacancy decontrol would:

- encourage landlords to upgrade buildings in order to attract tenants for decontrolled units and realize the maximum potential free market rent;
- discourage abandonment;
- establish an atmosphere conducive to massive construction of new housing by the private sector.

Spokesmen for the real estate industry agreed that decontrol would lead to substantial capital improvement in decontrolled housing. But other observers doubted that landlords would undertake significant rehabilitation of deterioriating properties in low-income areas of the city, such as East Harlem and the South Bronx. Major rehabilitation (installing modern kitchens, heating, etc.) would necessitate rents almost as high as those charged in new buildings, far beyond the reach of present tenants.[9] On the other hand, 'upper-income families that can afford it aren't going to move to the South Bronx no matter how handsomely renovated an apartment may be' (Bales 1972, 1). Even in a free market, poverty would hold some rents down and the deterioration-abandoment cycle would continue.

In order to make any major alteration in a building, the owner must apply for and receive a permit from the Department of Buildings. In New York City, the average monthly dollar amount invested in major alterations

8 The sample represents the distribution of apartments by borough fairly well but is biased towards larger (fifty units plus) and newer buildings. While one-third of the city's rent-controlled inventory consists of such buildings, 50 per cent of the units in the sample are in this category. Kristof ([n.d.]b, appendix I) concludes that 'both the average controlled and decontrolled rents shown in the sample are at slightly higher levels.'

9 A similar criticism can be made of MBR. The subsidy program proposed to assist low-income tenants finally amounted to an exemption from MBR increases of apartments occupied by low-income senior citizens.

(excluding code violation correction, required by MBR) decreased every month after decontrol. The number of permits declined in 1972, the first full year of decontrol, before rising slightly in 1973. All this led the Temporary Commission to conclude that:

> vacancy decontrol has failed to result in a significant increase in major renovations not already required by law in New York City. In fact, there has been a significant decrease of nearly $1,000,000 per month in renovations since the start of vacancy decontrol. (New York State 1974, 34)

On the other hand, Kristof ([n.d.]b, 2) reported that figures for the first ten months of 1973 show that the value of permits for additions and alterations to existing buildings were 81 per cent above those for 1972 and 82 per cent higher than those of 1971.

Landlords also claimed that decontrol would stimulate capital investment for new kitchens and appliances.[10] These improvements usually are made on a unit-by-unit rather than a building-wide basis, with the landlord choosing the apartments whose improvement will benefit him most - specifically, those that are decontrolled. The Temporary Commission (New York State 1974, 50) conducted a survey of major appliance dealers who sell replacements to New York landlords; it found that while the total number of applicances sold had increased by 16.6 per cent between 1969 and 1973, 8.3 per cent of the increase had taken place before decontrol and 8.3 per cent after. For his part, Kristof ([n.d.]b, 2) reported that, on average, $287 was spent between July 1971 and December 1973 for improvements to decontrolled units covered by his survey. Over the same period, another $216 per unit was spent on building-wide improvements. However, Kristof did not indicate the level of expenditures for unit and building-wide improvements before decontrol. Thus his findings are not necessarily inconsistent with those of the Temporary Commission.

Finally, real estate owners asserted that decontrol would stimulate rental housing construction. In 1971, only 365 privately financed units were completed in New York. In 1972, the first full year of vacancy decontrol, 2078 units were completed. However, as the Temporary Commission (New York State 1974, 63) noted, construction was also high in

10 Why this should be so is unclear, as controls provided for permanent rent increases related to the write-off period of such improvements.

1969 and 1970, when rent control permitted limited rent increases. Kristof ([n.d.]b, 2) also noted the surge of construction in 1972, claiming that some 20,000 privately financed units were started but that 'most of this new construction occurred under the tax exemption provisions of Section 421 of the Real Property Tax Law passed by the Legislature in 1971'. Section 421 offered the owner special tax exemption benefits if, among other things, he agreed to establish initial rents at 15 per cent below market rents and place the building's dwelling units under rent stabilization for ten years. If landlords and developers dislike government regulation per se, it is somewhat surprising that they should eschew the free market for a program limiting prospective rent.

It was noted earlier that vacancy decontrol provides the landlord with an incentive to secure vacant possession of a controlled unit. As tenants in controlled apartments could not be evicted by punitive rent increases, it was only to be expected that some New York landlords would diminish services, bring groundless dispossession proceedings, and otherwise make residency uncomfortable. HDA reported 533 tenant complaints of harassment in 1970, increasing to 1132 in 1971 and remaining at the higher level in 1972 and 1973; however, the number of cases given docket numbers declined. In the face of conflicting statistics, the Temporary Commission (New York State 1974, 76-7) felt that no conclusion could be reached concerning a statistical increase in harassment.

CURRENT EXPERIENCE

In 1974, the state and city adopted the Emergency Tenant Protection Act (ETPA), which ended vacancy decontrol in New York. ETPA placed all vacancy-decontrolled apartments in buildings of six or more units under rent stabilization; this affected some 240,000 to 325,000 units (Lett 1976, 18). The base rent for a 'pre-47 stabilized' unit was the rent charged and paid on June 30, 1974.[11] In addition, ETPA returned all vacancy-

11 Tenants could challenge the initial regulated rent by filing, within ninety days, a fair market rent appeal stating that the rent exceeded the fair market rent and documenting cases of comparable apartments renting for less. The owner could dispute the claim by showing examples of comparable units renting for more. However, the law required that a tenant's challenge be rejected if the rent charged did not exceed 1972-3 MBR (or MCR if greater) plus 27 per cent. If the rent exceeded this guideline, the CAB determined the fair market rent.

destablized units to stabilization effective July 1, 1974; 88,000 destabilized units were affected (Lett 1976, 18). The base rent for such units was limited to the rent that could have been charged on July 1, 1974 had the unit not been destabilized, plus 27 per cent.

EPTA also provided that rent-controlled units becoming vacant after July 1, 1974 would be decontrolled if in buildings of five or fewer units and placed under rent stabilization if in buildings of six or more units. In the latter case, the initial regulated rent is limited to the original MBR calculation[12] plus a percentage of MBR at the time the unit is stabilized. Under ETPA, all rent-controlled units will eventually be decontrolled but not necessarily freed of all rent regulation. Of the 642,000 controlled units in 1975, 402,000 (62.7 per cent) were still controlled in 1978, while 32,000 (5 per cent) were lost from the housing inventory, and 45,000 (7 per cent) were unaccounted for because of vacancy, conversions, mergers,

TABLE C.4

Gross rents, by control status, for matched renter-occupied housing units, New York City, 1975-8

Control status 75/8	Median Rent 1975	Median Rent 1978	Increase 1975-8	Increase 1975-8
All Units	$173	$208	$35	20.2%
Controlled/Controlled	$136	$165	$29	21.3%
Controlled/Pre-'47 Stabilized	$139	$213	$74	53.2%
Pre-'47 Stabilized/ Stabilized	$182	$210	$28	15.4%
Stabilized/Stabilized 1947 or later	$253	$292	$39	15.4%

SOURCE: Marcuse (1979, 262)

12 Or MCR - see note 4.

etc. (Marcuse 1979, 230). Rent increases for units going from controlled to stabilized status between 1975 and 1978, Marcuse (1979, 262) notes, were 'far and away the highest of any segment of the housing market, looked at in terms of control status' (see Table C.4). On the other hand, operating and maintenance costs increased 15.3 per cent over the same period, so the cost-rent gap continued to close (Marcuse 1979, 8).

Appendix D
Vacancy rates and rent increases in Canada

The choice of a decontrol strategy for Ontario, should decontrol be deemed desirable, would be easier to make were it known by how much rents would increase in the various submarkets given a sudden lifting of controls.

To determine this, one would have to obtain a robust relationship for each housing submarket, giving the time path of rents as a function of variables characterizing the current and past states of that submarket, related submarkets, and the economy. Inserting the current values of these variables into the relationships would give one the time path of rents following blanket decontrol in the various submarkets.

Unfortunately, such an exercise is not possible. One obstacle is the lack of adequate data. Virtually none of the available data on the housing markets in various cities in Ontario are broken down by submarket, and the reliability of much of the data that do exist is highly questionable. A problem of comparable magnitude is the inadequacy of current economic theory. As mentioned in Chapter 3, economists have made little progress in analysing markets characterized by excess demand; economic theory gives no insight as to how one goes about measuring the amount of excess demand in a housing market or in what way the amount of excess demand is related to market observables. Existing models of the housing market assume that it is, in most respects, competitive (in the sense of the word explained in Chapter 3); thus they imply that housing markets clear instantaneously - there is no search and there are no vacancies. It makes no sense in the context of these models to talk about the tightness of a market. So conventional theory provides no guidance for measuring the tightness of a housing market or relating it to the rate of rental increase.[1]

1 The branch of search theory that provides a microeconomic foundation for the Phillips' curve is applicable, but no one, to our knowledge, has formally extended it to the housing market.

Appendix D

An empirical regularity has, however, been observed between the tightness of an uncontrolled housing market (as measured by its vacancy rate) and the rate of rental increase. This appendix investigates this empirical relationship and uses the results to make some tentative predictions about rent increases in Toronto following blanket-lifting decontrol.

ECONOMIC RATIONALE FOR A RELATIONSHIP BETWEEN VACANCY RATES AND THE RATE OF RENT INCREASE

Consider a landlord in a housing market that is not subject to rent control. How does he decide what rent to charge per unit of housing service[2] in the next period? He knows what to expect from prospective tenants. Some will have visited several apartment buildings of similar quality in which rents are considerably higher than average; given their unlucky search experience, they will consider his apartment a bargain and sign a lease. However, others will have had to opposite experience; they will consider his price excessive, even though it may be below the market average. While some people will investigate many apartments, others will look at only one or two, either because they dislike apartment-hunting or because rents on the apartments they do look at are lower than they expected.

Assume the housing market is in stationary equilibrium. Given the search process, the landlord can accumulate enough information to estimate his demand curve. It is not flat, since if he raises his rents, some households will still consider his apartments a bargain on the basis of their search experience. Using his estimated demand curve, he can determine the profit-maximizing rent per unit of housing service; associated with it is an expected, profit-maximizing vacancy rate.[3]

Now relax the stationary state assumption and take into account the fact that conditions in the housing market are changing over time in a way that a landlord cannot predict perfectly. He still has some notion of what his demand curve looks like, yet he realizes that he may be mistaken;

2 The concept of 'a unit of housing service' was discussed in Chapter 3.

3 There is, of course, a conceptual inconsistency in this and other variants of the familiar search model. If all landlords behave in this way, then they all charge the same rent, and there is thus no reason for households to search.

therefore, he revises his estimated demand curve on the basis of his actual success in renting units. To simplify the argument, assume that the true demand curve is one of a family, all of which have a profit-maximizing vacancy rate of v*, and that the landlord knows this. Now suppose he sets what he thinks is the profit-maximizing rent per unit of housing service and is pleasantly surprised to find that his vacancy rate is lower than v*. Although he may have just been lucky, he quite naturally assumes that his demand curve is higher than he thought it was. In response, for the next period he will raise his real rent per unit of housing service. Similarly, if his vacancy rate is higher than v*, he will lower the real rent he charges next period.

The story is actually somewhat more complicated. In estimating where his demand curve lies, the landlord, realizing that he may have just been lucky during one period, is likely to consider his vacancy rate not just for this period but also for the past several periods. If his vacancy rate during this time has been consistently lower (higher) than v*, he now has more confidence that his demand is higher (lower) than he thought it was and, as a result, raises his rents by more (less). The argument is perhaps an overly elaborate way of providing an economic rationale for the intuitively reasonable hypothesis that the real rate of rental increase is negatively related to lagged vacancy rates.

The landlord also has imperfect knowledge of what the inflation rate will be. We assume that he forms his expectations about future inflation on the basis of past rates, then raises his nominal rents according to the inflation rate he expects, plus or minus the amount that depends on his vacancy rate experience. Thus we hypothesize that the rate of nominal rent increase per unit of housing service is negatively related to lagged vacancy rates and positively related to lagged inflation rates.

Chapter 4 considered the landlord's maintenance decision. On the basis of the characteristics of the market in which he operates, he will decide to run down his building at a certain speed. Now the rate of nominal rent increase per housing unit equals the rate of nominal rent increase per unit of housing service minus the rate of depreciation of the unit (that is, the rate of shrinkage of the number of units of housing service per housing unit). Thus the rate of nominal rent increase per housing unit is negatively related to lagged vacancy rates and the rate of deterioration of the unit and positively related to lagged inflation rates.

Appendix D

Unfortunately, the rate of deterioration is unobservable, but since it depends on local submarket conditions, the landlord's choice of the rate of nominal rent increase per housing unit depend on those conditions as well as on lagged vacancy rates and lagged inflation rates.

It is also assumed that all landlords in a particular housing submarket operate in the same way.[4]

The rate of nominal rent increase in city j is thus hypothesized to be

$$n_j^t = n(\{v_j^t\},\{i_j^t\},\Theta_j), \qquad (D.1)$$

where

n_j^t is the rate of nominal rent increase in city j in period t,

v_j^t is the vacancy rate in the city j in period t,

i_j^t is the inflation rate in city j in period t, and

Θ_j captures housing market conditions in city j.

The braces indicate that lagged as well as contemporaneous variables enter the relationship.

The relationship between the vacancy rate and the rate of nominal rent increase is obviously analogous to The Beveridge-Phillips' curve relationship between job vacancies and the rate of increase in money wages. On the basis of this analogy, the relationship between vacancy rates and the rate of nominal rent increases is hypothesized to be hyperbolic:

$$n_j^t = [(v_j^t)^{\alpha_0^j}(v_j^{t-1})^{\alpha_1^j}\ldots]\eta(\{i_j^t\},\Theta_j). \qquad (D.2)$$

ESTIMATION AND RESULTS

The rate of nominal rent increase upon blanket decontrol can be predicted as follows. First, specific forms of equation (D.2) are estimated, using

4 That is, problems of aggregation are assumed away.

data for a period during which controls were not applied. Then we assume that this estimated relationship holds for the period immediately after the blanket lifting of controls. Finally, insertion of recent values of the relevant independent variables give the predicted rates of nominal rent increase with the blanket lifting of controls.

Because of insufficient data, equation (D.2) could not be estimated separately for each Ontario city. Rather, it was necessary to treat a sample of Canadian, not just Ontario, cities, and also to assume that, for each i (inflation rate), is the α_i^j is the same for all j (all cities). We used rent and vacancy data for twelve Canadian cities - St. John's, Halifax, Saint John, Montreal, Ottawa, Toronto, Winnipeg, Regina, Saskatoon, Edmonton, Calgary, and Vancouver - as listed in Tables D.1 and D.2. National rather than city-specific inflation rates were used because it is probably the former that landlords consider in deciding on rent increases.

With the assumption that, for each i, the α_i^j is the same for all cities, equation (D.2) becomes

$$n_j^t = [(v_j^t)^{\alpha_0}(v_j^{t-1})^{\alpha_1}\ldots]\eta(\{i^t\},\theta_j). \qquad (D.3)$$

The first specification of this equation assumed that lagged inflation rates, as well as lagged vacancy rates, are related to n_j^t in hyperbolic fashion; that is,

$$n_j^t = k_j\,[(v_j^t)^{\alpha_0}(v_j^{t-1})^{\alpha_1}\ldots][(i^t)^{\beta_0}(i^{t-1})^{\beta_1}\ldots], \qquad (D.4)$$

where k_j is a city-specific intercept term that capture differences in the various cities' housing market characteristics. Taking the log of both sides of equation (D.4) gives

$$\ln n_j^t = \ln k_j + (\alpha_0 v_j^t + \alpha_1 v_j^{t-1}\ldots) + (\beta_0 i^t + \beta_1 i^{t-1})\ldots, \qquad (D.5)$$

which was the first equation estimated.

However, the relationship between nominal price (rent) increases and lagged inflation rates is usually taken to be linear, in which case (D.3) becomes

TABLE D.1

Vacancy rates: twelve Canadian cities

	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974
St. John's	--	--	--	--	--	--	18.9	20.7	3.6	1.0	0.4	0.6
Halifax	4.9	4.4	5.4	3.8	2.8	0.5	0.5	2.6	4.1	4.8	2.5	2.7
Saint John	--	--	--	--	--	--	0.5	2.3	1.0	0.5	1.6	0.1
Montreal	--	--	--	4.5	1.2	5.0	7.6	8.2	7.2	5.7	3.8	2.6
Ottawa	--	--	--	7.7	2.2	1.5	1.7	2.3	2.0	2.3	2.2	3.9
Toronto	4.4	2.8	1.6	1.0	1.2	1.5	2.7	2.8	3.0	3.3	2.1	1.0
Winnipeg	3.7	5.6	4.9	4.1	1.7	1.6	1.6	2.6	3.5	5.4	4.1	2.9
Regina	--	--	--	--	--	--	10.7	10.7	6.6	3.1	1.6	0.7
Saskatoon	--	--	--	--	--	--	10.2	20.4	16.9	8.6	6.4	1.5
Edmonton	9.2	13.0	6.5	2.8	2.8	2.8	3.7	5.7	6.3	7.6	8.3	5.5
Calgary	14.4	11.6	8.0	5.8	1.6	1.3	1.7	5.8	10.7	8.9	8.6	5.7
Vancouver	4.2	4.7	4.0	1.5	1.0	1.3	1.2	2.7	4.1	2.4	1.0	0.3

NOTE: Rates are percentages, calculated as of June for the year indicated.
SOURCE: CMHC, (1966, 1969, 1972, 1975).

TABLE D.2

Rent indexes: twelve Canadian cities
(1971 = 100)

	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975
St. John's	--	--	--	--	--	--	99.6	99.9	100.0	102.7	104.7	109.3	114.6
Halifax	82.5	82.9	83.3	84.5	86.3	88.5	92.6	98.0	100.0	101.4	103.2	105.5	106.5
Saint John	--	--	--	--	--	--	95.8	98.0	100.0	102.5	105.2	110.1	118.6
Montreal	--	--	--	88.6	90.8	93.7	97.0	99.2	100.0	100.3	100.9	103.3	107.6
Ottawa	--	--	--	81.1	82.7	86.7	92.0	97.3	100.0	102.0	104.8	108.4	112.6
Toronto	78.8	79.0	79.8	82.1	86.4	90.8	94.9	98.1	100.0	101.3	102.9	105.8	112.0
Winnipeg	86.8	86.8	86.8	87.1	88.3	90.7	94.8	97.9	100.0	101.7	103.7	109.4	113.1
Regina	--	--	--	--	--	--	98.9	100.4	100.0	101.7	103.7	109.4	122.7
Saskatoon	--	--	--	--	--	--	102.0	101.7	100.0	100.3	104.7	110.6	120.4
Edmonton	83.2	82.6	82.6	83.4	85.6	91.1	95.2	98.2	100.0	103.2	104.5	106.2	113.7
Calgary	76.6	76.3	76.5	77.8	82.2	88.3	94.5	99.1	100.0	100.4	101.1	102.2	108.9
Vancouver	80.2	80.3	81.0	81.9	86.1	90.9	93.8	98.0	100.0	101.4	103.2	109.4	116.9

NOTE: The percentage rate of nominal rental increase in year t in city j, n_j^t, was calculated as

$n_j^t = 100\ (R_j^t - R_j^{t-1}) \div 2(R_j^t + R_j^{t-1})$, where R_j^t is the value of the rent index in city j at time t.

SOURCE: For years prior to 1972, Dominion Bureau of Statistics; for 1972 and beyond, information kindly provided by Douglas Dexter of Statistics Canada.

Appendix D

$$n_j^t = c_j + \hat{k}\,[(v_j^t)^{\alpha_0}(v_j^{t-1})^{\alpha_1}\ldots] + \beta_0 i^t + \beta_1 i^{t-1}\ldots, \qquad (D.6)$$

which was the second equation estimated.

We experimented with a variety of lag structures for both equations, and in each case the best equation was obtained using only one-period lagged variables.

The results for the first equation are given in Table D.3. The estimated elasticity of nominal rent increase with respect to the vacancy rate is -.782, while the elasticity of nominal rent increase with respect to the inflation rate is .645. Unfortunately, the current inflation rate lies outside the range of inflation rates in the sample considered. Thus, quite apart from the other problems with the equation, the propriety of using it for predictive purposes is questionable. Despite this qualification, it is interesting to see what the equation predicts for the annual rate of increase in nominal rents in Toronto after the blanket lifting of controls. Using a lagged vacancy rate of 1 per cent and a lagged inflation rate of 12 per cent gives an estimated annual rate of increase in Toronto nominal rents of 8.72 per cent; with a lagged vacancy rate of 0.5 per cent, one obtains an estimate of 15.00 per cent.

The results for the second equation are given in Table D.4. As expected, the rate of nominal rent increase is negatively related to the vacancy rate and positively related to the inflation rate, but the coefficient on the inflation rate is remarkably small (.208). With a lagged vacancy rate of 1 per cent and a lagged inflation rate of 12 per cent, the second equation yields an estimated annual rate of increase in nominal rents in Toronto of 4.62 per cent; the corresponding figure with a lagged vacancy rate of 0.5 per cent is 6.44 per cent.

To ascertain which of these specifications is superior, one should employ non-nested hypothesis testing.

WEAKNESSES OF THE ESTIMATING PROCEDURE

For several reasons, we regard the procedure just described as suspect and the results as dubious.

- The current inflation rate lies outside the range of inflation rate in the sample.

TABLE D.3

Econometric results for twelve cities of $\ln n_j^t = k_j + \alpha_1 \ln v_j^{t-1} + \beta_1 \ln i^{t-1}$

$\alpha_1 = -.782$ (0.0870); $\beta_1 = .654$ (.157); $\ell = -76.4$;

$R^2 = .671$; $\bar{R}^2 = .622$; $F = 13.8$

Specific city	Constant terms	Standard error
St. John's	-.0541	.384
Halifax	.519	.302
Saint John	.00381	.366
Montreal	.666	.315
Ottawa	.950	.316
Toronto	.541	.304
Winnipeg	.590	.300
Regina	.979	.350
Saskatoon	1.331	.363
Edmonton	1.248	.300
Calgary	.988	.300
Vancouver	.482	.305

NOTE: Equations estimated using OLS. Standard errors are shown in parentheses.

- During the period of the sample, inflation rates were rising. The small coefficient on the inflation rate in the second equation can be explained by landlords expecting that the inflation rate would fall back to a 'normal' level. But by now people have grown used to a high rate of inflation. With a sustained rate of inflation, the coefficient on β in the second equation should be about unity.

- The rental accommodation and vacancy rate series are of questionable quality.[5]

- The confidence intervals on the estimated annual rates of nominal rent increase in Toronto are large.

- It may well be that the α's vary from city to city.

5 See Fallis (1980, 83).

Appendix D

TABLE D.4

Econometric results for twelve cities of $n_j^t = c_j + \hat{k}\,(v_j^{t-1})^{\alpha_1} + \beta_1\, i^{t-1}$

$\tilde{k} = -4.55\ (3.64)$; $\alpha_1 = .287\ (.165)$; $\beta_1 = .208\ (0.798)$;

$\ell = -152$; SSR = 119; SER = 1.172.

Specific city	Constant terms	Standard error
St. John's	8.11	3.60
Halifax	7.62	0.714
Saint John	6.43	0.795
Montreal	8.13	0.745
Ottawa	8.62	0.755
Toronto	7.67	0.733
Winnipeg	7.41	0.736
Regina	8.52	0.790
Saskatoon	9.87	0.773
Edmonton	8.96	0.710
Calgary	9.46	0.682
Vancouver	7.82	0.724

NOTE: Equations estimated using nonlinear least squares. Standard errors are shown in parentheses.

- Immediately after the blanket lifting of controls, a landlord faced with a given lagged vacancy rate and lagged inflation rate may increase his rents by more than if there had been no rent control. He may try to make up for lost time. Alternatively, a vacancy rate of a certain amount in a rent-controlled market may not signal the same thing about the state of demand as the identical vacancy rate in an uncontrolled market.

- The theory on which the estimating equations are based is ad hoc.

- The treatment of the error structure in the estimated equations is crude.

Even if the procedure is reasonable, the results derived from it - predicted average annual rates of nominal rent increase for an entire local housing market - are not as disaggregated as one would like, since rates of nominal rent increase can vary markedly over submarkets within a local

market. The rate of nominal rent increase might well be much higher for certain submarkets in that local market.

In conclusion, while our estimated equations suggest that rent increases in Toronto are unlikely to be consistently high after blanket decontrol, our results are unreliable and may hide substantial variations across submarkets. Thus we judge the exercise performed in the appendix to be unpersuasive, though interesting in some respects.

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